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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1941

No. 757

PRUDENCE REALIZATION CORPORATION, PETITIONER,

vs.

A. JOSEPH GEIST, TRUSTEE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED NOVEMBER 24, 1941.

CERTIORARI GRANTED JANUARY 5, 1942.

SUPREME COURT OF THE UNITED STATES

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INDEX.

JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., JANUARY 26, 1942.

—8512

[fol. 1]

IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act

Nos. 27496 and 27028

In the Matter of THE PRUDENCE COMPANY, INC., Debtor

In the Matter of AMALGAMATED PROPERTIES, INC., Debtor

In the Matter of a Plan of Reorganization of AMALGAMATED PROPERTIES, INC., Debtor, in Respect of the Zo-Gale First Mortgage Participation Certificates

PRUDENCE REALIZATION CORPORATION, Appellant

A. JOSEPH GEIST, Trustee, Appellee

STATEMENT UNDER RULE 13

This proceeding was commenced on May 13, 1940, by the service on Prudence Realization Corporation of the petition of A. Joseph Geist as trustee for an order declaring that the interest of Prudence Realization Corporation in and to the outstanding certificates in the sum of $818.67 and in and to the unissued certificates in the principal amount of $7,200 of the Zo-Gale Realty Co. Issue is subject and subordinate to the certificates issued by Prudence-Bonds [fol. 2] Corporation, guaranteed by The Prudence Company, Inc., and held by the general public, and that payments of principal and interest on the certificates issued and unissued held by Prudence Realization Corporation should be deferred until the certificate holders have been paid in full the principal and interest guaranteed them under their certificates, and for such other and further relief as to the Court may seem proper.

The only parties who have appeared or taken any part in the proceeding are A. Joseph Geist, as trustee, petitioner, and Prudence Realization Corporation, the respondent.

The answering affidavit of William T. Colvin, as President of Prudence Realization Corporation, was filed on

September 26, 1940, and the replying affidavit of A. Joseph Geist, as trustee, was filed on October 23, 1940.

On January 25, 1941, Hon. Grover M. Moscowitz, United States District Judge, handed down a decision granting the petition, and on January 30, 1941, made and entered an order declaring the interest of Prudence Realization Corporation in and to the issued and unissued certificates of the Zo-Gale Realty Co. Issue subordinate to the interest of third party certificate holders, and determining that Prudence Realization Corporation is not entitled to any distribution of principal or interest out of the trust estate on account of its certificates until third party certificate holders have been paid in full the principal and interest guaranteed under their certificates.

A notice of appeal from the order of January 30, 1941, was dated and filed in the office of the Clerk of the United States District Court for the Eastern District of New York on February 13, 1941.

[fol. 3] IN UNITED STATES DISTRICT COURT, EASTERN DISTRICT OF NEW YORK

In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act

Nos. 27496 and 27028

In the Matter of THE PRUDENCE COMPANY, INC., Debtor

In the Matter of AMALGAMATED PROPERTIES, INC., Debtor

In the Matter of a Plan of Reorganization of AMALGAMATED PROPERTIES, INC., Debtor, in Respect of the Zo-Gale First Mortgage Participation Certificates

ORDER TO SHOW CAUSE

Upon the annexed petition of A. Joseph Geist, as trustee, duly verified the 7th day of May, 1940, upon the guaranteed participation certificates, a specimen copy of which is annexed hereto, upon the guaranty agreement executed by The Prudence Company, Inc., annexed hereto, and upon all of the papers and proceedings heretofore had herein, and sufficient reason appearing therefor,

Let the Trustees of The Prudence Company, Inc. and the Prudence Realization Corporation show cause, if any there be, before this Court in Room 224 of the United States Courthouse, Washington and Johnson Streets, Borough of [fol. 4] Brooklyn, City and State of New York, on the 21st day of May, 1940, at 9:30 o'clock in the forenoon of that day, or as soon thereafter as counsel can be heard, why an order should not be made and entered herein declaring that the interest of the Prudence Realization Corporation in and to the outstanding certificates held by the Prudence Realization Corporation in the sum of $816.67 of the Zo-Gale Realty Co. Inc. issue and to the principal amount of the mortgage in the sum of $7,200 of said issue, not represented by outstanding certificates, is subordinate to the certificates issued by Prudence Bonds Corporation and guaranteed by The Prudence Company, Inc. held by certificate holders and that the Trustees of The Prudence Company, Inc., and its successor, Prudence Realization Corporation, are not entitled to any distribution out of the trust estate on account of the shares held by Prudence Realization Corporation until the certificate holders have been paid in full the principal and interest guaranteed them under their certificates, and for such other, further and different relief as to the court may seem just and proper in the premises.

Sufficient Reason Appearing Therefor, let service of a copy of this order and the petition upon which same is based upon Prudence Realization Corporation or upon Irving L. Schanzer, attorney for the Prudence Realization Corporation, on or before the 17th day of May, 1940, be deemed good and sufficient service.

Dated, Brooklyn, New York, May 13th, 1940.

Grover M. Moscowitz, U. S. D. J.

[fol. 5] In United States District Court, Eastern District of New York

[Same Title]

Petition of A. Joseph Geist, Read in Support of Motion

To the Honorable Judges of the United States District Court for the Eastern District of New York:

The petition of A. Joseph Geist respectfully shows to this Court and alleges:

First. That by order duly made and entered in the United States District Court for the Eastern District of New York, on February 1, 1935, the petition of The Prudence Company, Inc. for reorganization under Section 77B of the Bankruptcy Act was approved as duly and properly filed.

Second. That by order duly made and entered in the United States District Court for the Eastern District of New York on March 17, 1936, the petition of Amalgamated Properties, Inc. for reorganization under Section 77B of the Bankruptcy Act was approved as properly filed and was approved as properly filed in the proceedings of The Prudence Company, Inc., Debtor.

Third. That at the time of the filing of the petition of Amalgamated Properties, Inc., The Prudence Company, Inc. was the owner of all of the stock of Amalgamated Properties, Inc., and the trustees of The Prudence Company, Inc., Debtor, appointed by order of the United States District Court for the Eastern District of New York constituted the entire Board of Directors and all of the officers of Amalgamated Properties, Inc.

[fol. 6] Fourth. That on January 28, 1925, The Prudence Company, Inc., the then owner and holder of the first mortgage covering premises #202 Riverside Drive, New York City, and the Zo-Gale Realty Co., Inc., as owner of said premises, entered into a consolidation and extension agreement, whereby the mortgages aggregating the sum of $480,000, affecting said premises, were consolidated and the time of payment of the principal sum of $480,000 was extended to April 1, 1935. Said consolidation and extension agreement was recorded in the office of the Register of New York County on February 2, 1925, in Liber 3526 of Mortgages, Page 456.

Fifth. That thereafter, The Prudence Company, Inc., by an assignment dated January 28, 1925, recorded in the office of the Register of New York County on February 2, 1925, in Liber 3526 of Mortgages, Page 466, assigned the mortgages consolidated and extended pursuant to the agreement hereinbefore described to Prudence Bonds Corporation.

Sixth. That simultaneously therewith, The Prudence Company, Inc. and the Prudence Bonds Corporation en-

tered into an agreement, which provided that the interest of Prudence Bonds Corporation in said consolidated mortgages was $450,000 and that such interest was senior to the interest owned by The Prudence Company, Inc., in the sum of $30,000.

Seventh. That Prudence Bonds Corporation, upon acquiring title to the aforesaid senior interest in said consolidated mortgages, sold undivided interests therein evidenced by guaranteed participation certificates to the public. A specimen copy of the guaranteed participation certificates sold to the public is annexed hereto, marked Exhibit "1", and made a part hereof with the same force and effect as if herein set forth at length.

[fol. 7] Eighth. That The Prudence Company, Inc., pursuant to the terms of a guaranty agreement dated February 5, 1925, guaranteed the payment of principal and interest to the holders of the participation certificates sold by Prudence Bonds Corporation with respect to the consolidated first mortgage in the principal sum of $450,000, which certificates are known as the "Zo-Gale Realty Co. Inc. issue". The mortgage was thereafter reduced by payment to the sum of $390,000. A copy of said guaranty agreement is annexed hereto and marked Exhibit "2" and made a part hereof with the same force and effect as if herein set forth at length.

Ninth. That thereafter, and prior to April 1, 1935, the junior participation interest of $30,000 held by The Prudence Company, Inc. was paid in full.

Tenth. That said guaranty agreement was transferred and delivered to A. Joseph Geist, as trustee for the benefit of the certificate holders, pursuant to the plan of reorganization and the orders of confirmation and consummation.

Eleventh. That by order duly made and entered in the United States District Court for the Eastern District of New York on the 19th day of February, 1938, hereinafter called the "order of confirmation", a plan for the reorganization of the Zo-Gale Certificate Issue, affecting premises #202 Riverside Drive, Borough of Manhattan, City of New York, sponsored by Amalgamated Properties, Inc. was duly approved and confirmed as amended by order of the United States District Court for the Eastern District of New York dated December 10, 1937.

[fol. 8] Twelfth. That the order of confirmation entered on the 19th day of February, 1938, provides in paragraph "7" thereof as follows:

"Some question has arisen with respect to the rights of The Prudence Company, Inc. on account of $816.67 of Certificates held or claimed by that Company and its Trustees, and question has also arisen with respect to the interest in said Mortgage (being the $7,200 principal amount thereof not represented by outstanding Certificates) owned or claimed by The Prudence Company, Inc. and its Trustees and/or by Prudence-Bonds Corporation and its Trustees. Anything in the Amended Plan to the contrary notwithstanding, the Trustee under the Amended Plan shall make no distributions of cash and/or securities on account of the Certificates now held or claimed by The Prudence Company, Inc. and its Trustees, or on account of the part of said Mortgage which is not represented by outstanding Certificates, unless and until it shall have been finally adjudicated by a court of competent jurisdiction that The Prudence Company, Inc. and its Trustees and/or Prudence-Bonds Corporation and its Trustees are entitled to share in the trust estate by reason thereof. Pending final adjudication of such question, said Trustee shall hold in escrow the share of any cash and/or securities distributable under the Amended Plan, to which such Certificates held or claimed by The Prudence Company, Inc. and/or its Trustees would be entitled, if owned and held by someone other than The Prudence Company, Inc. and its Trustees, and the share of any cash and/or securities distributable thereunder to which the part of said Mortgage which is not represented by outstanding Certificates would be entitled if it were represented by outstanding Certificates owned and held by some-[fol. 9] one other than The Prudence Company, Inc. and its Trustees and/or Prudence-Bonds Corporation and its Trustees, and the cash and/or securities so held in escrow by said Trustee shall be distributed by the Trustee without interest, in accordance with the final adjudication of such court: Pending such adjudication, the Certificate so held or claimed by The Prudence Company, Inc., and its Trustees, and the part of said Mortgage which is not represented by outstanding Certificates shall not be subject to purchase out of the sinking fund provided for in said Amended Plan. Without prejudice to the rights, if any, of The Prudence

Company, Inc. and its Trustees, the Trustee under said Amended Plan shall on the closing under said Plan, execute and deliver to Charles H. Kelby and Clifford S. Kelsey, as Trustees of Prudence-Bonds Corporation, a certificate in the name of said Trustees of Prudence-Bonds Corporation, evidencing an interest in the trust estate of $7,200 principal amount and interest, subject, however, to the terms hereof."

Thirteenth. The plan of reorganization, as amended by order dated December 10th, 1937, provides in part thereof as follows:

"The Plan does not contemplate a reorganization of the bond of the Zo-Gale Realty Co., Inc., which is secured by the mortgage, nor a reorganization of the guaranty of The Prudence Company, Inc., and all rights of certificate holders against each of these parties are expressly reserved."

Fourteenth. That on the 9th day of April, 1939, an order, hereinafter called the "order of consummation", was duly made. Said order was entered in the office of the Clerk [fol. 10] of the United States District Court for the Eastern District of New York on the 12th day of April, 1938.

Fifteenth. That your petitioner, as trustee, duly qualified by executing and acknowledging his acceptance of the declaration of trust required to be executed by the order of consummation, and a copy of said trust declaration was thereafter recorded in the office of the Register of the County of New York, and your petitioner has been and now is acting as trustee thereunder.

Sixteenth. On May 20th, 1938, the Prudence Bonds Corporation, Debtor, in reorganization proceedings pending in the United States District Court for the Eastern District of New York, under Section 77B of the Bankruptcy Act, No. 26545, and Charles H. Kelby and Clifford S. Kelsey, as trustees pursuant to the plan of reorganization and the orders of confirmation and consummation assigned, set over, transferred and delivered to your petitioner, as trustee, all right, title and interest of the assignors in and to said bonds, mortgages and other documents then in the possession of the Trustees of Prudence Bonds Corporation.

Seventeenth. That Amalgamated Properties, Inc., pursuant to the plan of reorganization, order of confirmation

and the order of consummation, executed a deed conveying the fee title to the premises to A. Joseph Geist, as trustee, subject to the mortgage in the sum of $390,000, which was extended by agreement between A. Joseph Geist, as trustee, and Amalgamated Properties, Inc.

Eighteenth. That your petitioner herein is the holder of the bond and mortgage and of the fee to the premises and of all the securities delivered pursuant to the plan of reorganization and the orders of confirmation and consum-
[fol. 11] mation as trustee, and manages and operates the premises and administers the mortgage, which constitutes the trust estate, for the benefit of the holders of participation certificates, as trustee.

Nineteenth. That thereafter, your petitioner, as trustee, pursuant to the provisions of paragraph "7" of the order of confirmation, and pursuant to the order of consummation, executed and delivered a certificate to the Trustees of The Prudence Company, Inc., certifying to the interest of the said Trustees of an undivided share of $7,200 in the aforesaid mortgage of $390,000 held by your petitioner, as trustee.

Twentieth. That the Trustees of The Prudence Company, Inc. are the registered owners of the following Zo-Gale First Mortgage Participation certificates: #B-2908 in the sum of $800, and #B-2909 in the sum of $16.67.

Twenty-first. That Prudence Bonds Corporation and The Prudence Company, Inc. defaulted in the performance of the terms, covenants and conditions contained in the guaranteed mortgage certificates and in the guaranty agreement, and failed to pay to the holders of the guaranteed mortgage certificates the principal and interest which became due and payable on the guaranteed mortgage participation certificates held by the certificate holders.

Twenty-second. That at all times herein mentioned, Prudence Realization Corporation was and still is a domestic corporation, organized and existing under and by virtue of the laws of the State of New York; the said corporation was organized pursuant to an order of the United States District Court for the Eastern District of New York dated April 21, 1939, in the Matter of The Prudence Company, Inc., Debtor,

[fol. 12] in the Matter of the General Plan of Reorganization proposed by the Reconstruction Finance Corporation; the said corporation succeeded to all of the assets of the trustees of The Prudence Company, Inc., Debtor, including the certificates of the Zo-Gale First Mortgage Participation issue, hereinbefore described.

Twenty-third. That the order of confirmation entered on the 19th day of February, 1938, provides in paragraph "30" thereof as follows:

"The Court retains jurisdiction to hear and determine all questions arising under paragraph 7 of this order with regard to the treatment of Certificates and interests in the trust estate created under the Amended Plan which are held or claimed by The Prudence Company, Inc. and its Trustees and by Prudence-Bonds Corporation and its Trustees, and to take action on any application for an adjudication regarding the final disposition of the cash and/or securities held in escrow pursuant to said paragraph 7 of this order; and the Trustees of The Prudence Company, Inc. and/or the Trustee to be appointed pursuant to the Amended Plan are hereby granted leave to apply at any time at the foot of this order for such adjudication."

Wherefore, petitioner prays for an order declaring that the interest of the Prudence Realization Corporation in and to the outstanding certificate in the sum of $816.67, and to the principal amount of the mortgage in the sum of $7,200 not represented by outstanding certificates is subordinate to the certificates issued by Prudence Bonds Corporation and guaranteed by The Prudence Company, Inc. held by the certificate holders, and that the Trustee of The Prudence Company, Inc. and its successor, Prudence [fol. 13] Realization Corporation, is not entitled to any distribution out of the trust estate on account of the shares held by it until the certificate holders have been paid in full the principal and interest guaranteed them under their certificate, and for such other and further relief as to the Court may seem just and proper in the premises.

Dated, New York, May 7th, 1940.

A. Joseph Geist, Petitioner.

(Verified May 7, 1940.)

Exhibit "1" Annexed to Petition.

No. B00000 $

Registered

Prudence First Mortgage Certificate

Guaranteed by

The Prudence Company, Inc.

Prudence-Bonds Corporation, hereinafter called "the Corporation," has received from — for the purchase of, and hereby assigns to the purchaser, an undivided share equal to that amount, with interest thereon at the rate of —% per annum, in the bond of — for $— dated — 19—, due — 19—, and in the first mortgage securing the same, covering

[fol. 14] Interest payable — 1st and — 1st from —
Date — 19—.

Specimen, — — —, Assistant Secretary; specimen, — — —, Vice-President.

This bond and mortgage, together with the guarantee of The Prudence Company, Inc., guaranteeing to holders of this and similar certificates payment of principal and interest, are held by Central Union Trust Company of New York as Depositary and Agent for the holders of such certificates which shall never aggregate more than the amount of principal remaining unpaid on said bond and mortgage upon the following terms and conditions which are agreed to by the holder of this certificate.

1. Central Union Trust Company of New York holds and shall continue to hold said bond and mortgage, said guarantee, and the other instruments and evidences of title relating thereto for the benefit of the purchaser and any other parties interested therein.

2. The Corporation upon the receipt of the interest and principal of said bond and mortgage shall distribute the same pro rata among the parties entitled thereto.

3. The Corporation and/or the Guarantor shall have full power to take any action it may deem necessary or desirable in order to enforce any of the provisions of

said bond and mortgage and to protect the mortgage security.

[fol. 15] 4. The Corporation may for its own corporate account, be the holder or pledgee of similar shares in said bond and mortgage.

5. The Corporation may take up and cancel this certificate at any time on thirty days' notice in writing to the purchaser and payment at one of its offices to be designated in such notice of the amount then owing to the purchaser for the principal and interest.

While the bond secured by the mortgage mentioned in this certificate is payable by its terms on its due date, the policy of The Prudence Company, Inc. entitles it at its option to a period of eighteen months thereafter in which to collect the principal. Regular payment of interest meanwhile is guaranteed.

Central Union Trust Company of New York hereby certifies that the bond and mortgage within referred to, together with the guarantee of payment therein mentioned, the insurance policies and other instruments and evidences of title relating thereto are held by it for the benefit of the parties interested in said bond and mortgage; that the interest of the holder of this certificate in said bond and mortgage is not subordinate to any other shares thereof and is not subject to any prior interest therein.

Central Union Trust Company of New York further certifies that this certificate and all other certificates at any time issued against said bond and mortgage will not exceed the amount of principal owing on said bond and mortgage.

Date —— 19—.

Central Union Trust Company of New York, by —— — ——, Assistant Treasurer, Assistant Secretary.

[fol. 16] No. B00000

Registered

Prudence First Mortgage Certificate

Guaranteed by

The Prudence Company, Inc.

$

Per Cent

Due —— —, ——

Interest payable

The Prudence Company, Inc., hereby certifies and guarantees to the holder of the within certificate that it has guaranteed payment of the principal of the bond and mortgage within mentioned when due or within eighteen months thereafter, and payment of the interest thereon, when due, by guarantee referred to within and now in the possession of the Depositary.

Date —— 19—.

The Prudence Company, Inc., —— — ——, Treasurer; specimen, —— — ——, Secretary.

[fol. 17] Exhibit "2" Annexed to Petition

The Prudence Company, Inc., (hereinafter designated as "this corporation") in consideration of One Dollar and the terms of guarantee named below, guarantees to each and every holder of the certificates of participation issued by Prudence-Bonds Corporation in and to certain bonds and mortgages described in Schedule A who shall give this Corporation notice and proof of ownership (each and every person and corporation to whom under this clause this guarantee runs being hereinafter included in the designation "the insured"):

First: Payment of interest when due according to the terms of each such certificate issued.

Second: Payment of the principal, and of every installment thereof, as soon as collected, but in no event later

than eighteen months after it shall have become due and payment thereof shall have been demanded in writing by the insured, with regular payment meantime of interest at the rate guaranteed:

Terms of Guarantee

By the acceptance of this guarantee this Corporation is made irrevocably the agent of the insured until said certificate of the insured be paid, with the exclusive right, but at its own expense, to sue for and receive the proceeds of any policy of title insurance or fire insurance covering the mortgaged premises; and to collect the principal and interest as it falls due on said bonds and mortgages aforesaid.

This guarantee is subject to the conditions annexed hereto.

[fol. 18] In Witness Whereof, The Prudence Company, Inc. has caused its corporate seal to be hereunto affixed and this instrument to be signed by two of its officers.

Dated the 5th day of February, 1925.

The Prudence Company, Inc., B. Pender, Gertrude L. T. Trundy, Ass't. Secretary.

Schedule A

The bonds covered by this guarantee were made by:

William T. Evans to the Union Dime Savings Bank, dated March 5, 1913, in principal amount $390,000 on which there is now due $362,500.

202 Riverside Drive Corporation to Terrace Court Co. Inc., dated February 19, 1920, in principal amount $95,000 on which there is now due $47,500.

Zo-Gale Realty Co., Inc. to 202 Riverside Drive Corporation, dated August 16, 1920, in principal amount $72,500 on which there is now due $49,000.

Zo-Gale Realty Co., Inc. to The Prudence Company, Inc., dated January 28, 1925 in principal amount $21,000.

All of the above bonds have been duly consolidated and extended pursuant to an agreement between Zo-Gale Realty Co. Inc. and The Prudence Company, Inc. dated January 28, 1925 and they now secure payment of the sum of $480,000 with interest. The mortgages given to secure

[fol. 19] said bonds have been duly recorded and were made between the same parties bearing the same dates as the bonds.

The proper assignments of the above bonds and mortgages into The Prudence Company, Inc. have been duly recorded and an assignment of all the above bonds and mortgages, as consolidated, have been executed by The Prudence Company, Inc. to Prudence-Bonds Corporation, and duly recorded.

This Corporation holds as collateral to said bonds and mortgages a policy of title insurance by Title Guarantee and Trust Company running in favor of Prudence-Bonds Corporation as mortgagee, and policies of fire insurance in the sum of Four Hundred and Fifty Thousand Dollars ($450,000) covering the real property described in said mortgage, which policies are delivered to and deposited with the Central Union Trust Company of New York, as Depositary, for the benefit of the holders of said participating certificates.

The interest of Prudence-Bonds Corporation in this mortgage is to the extent of ***$450,000*** only. This interest is prior and is equivalent to a first mortgage for ***$450,000*** and certificates issued are not to exceed ***$450,000.***

Conditions

This Corporation is bound:

1—To conduct, without expense to the insured, any action or proceedings which it may deem necessary to enforce the performance of any covenants contained in said bond or mortgage.

2—To continue this guarantee on any extension of said mortgage, unless this Corporation shall elect to collect the amount secured by said mortgage.

[fol. 20] 3—To keep the mortgaged premises insured against fire by policies of fire insurance, having mortgagee clause attached, issued by companies authorized to do business in the State of New York.

4—To require the owner to pay all fire insurance premiums, taxes, assessments and water-rates, which are required to be paid by the terms of said mortgage.

5—To consent to the assignment of this guarantee, subject to the terms thereof, to any subsequent owner and

holder of said participating certificates who shall give this Corporation prompt notice and proof of ownership. Unless such notice and proof be given, no subsequent owner or holder shall be entitled to the benefit of this guarantee.

The Insured is bound:

1—To permit this Corporation to collect all interest and the principal secured by said bond and mortgage, and to refrain from collecting any part of the interest or principal secured by said bond and mortgage except through this Corporation.

2—To permit this Corporation to enforce payment of any sums which may be or become due under said bond and mortgage or under any policy of title or fire insurance issued on the premises covered by said mortgage, and to render such reasonable assistance to that end as this Corporation may require, but not to incur any expense in so doing.

All the notices by the insured to this Corporation or by this Corporation to the insured, required or given under this guarantee, shall be in writing and may be sent by mail.

[fol. 21] IN UNITED STATES DISTRICT COURT, EASTERN DISTRICT OF NEW YORK

[Same title]

AFFIDAVIT OF WILLIAM T. COWIN, READ IN OPPOSITION TO MOTION

STATE OF NEW YORK,
County of New York, ss:

William T. Cowin, being duly sworn, deposes and says:

That deponent is President of Prudence Realization Corporation and is the sole remaining Trustee of The Prudence Company, Inc., Debtor. This affidavit is being submitted in opposition to the application of A. Joseph Geist, as Trustee of the Zo-Gale First Mortgage Participation Certificate Issue, for an order determining that the interests of Prudence Realization Corporation in the Zo-Gale Cer-

tificate Issue are subordinate to the certificates held by the general public.

The source of deponent's information are conversations had with employees of Prudence Realization Corporation who were formerly employees of the Trustees and of The Prudence Company, Inc., and examination of the various books of account and records as well as conversations with counsel to Prudence Realization Corporation.

In order to set forth clearly the history of the certificate issue here involved and the facts pertinent to the determination of the parity question, your deponent sets forth in chronological order the sequence of events leading to the instant application.

The Prudence Company, Inc. was an investment corporation organized under Article VII of the New York Banking Law in 1919. It engaged in a guaranty mortgage business and guaranteed single mortgages and 54 certificate [fol. 22] issues in addition to guaranteeing 18 issues of bonds of Prudence-Bonds Corporation, an affiliate. It also issued securities on which it was the primary obligor, including a bond issue generally described as the "1961 Bond Issue" and a certificate issue known as "Prudence B Series". The common stock of Prudence was owned by New York Investors, Inc., the preferred stock being held by the general public. New York Investors, Inc. also owned all of the stock of Prudence-Bonds Corporation.

The certificate issues were created in the following manner: Prudence, having acquired a bond and mortgage with its own funds, assigned such bond and mortgage to Prudence-Bonds Corporation which in turn assigned the said bond and mortgage to a corporate depositary. In some instances a deposit agreement was executed between Prudence-Bonds Corporation and the depositary and in some cases the deposit consisted of a letter of transmittal executed by Prudence-Bonds Corporation and delivered to the depositary together with the instruments of assignment of the bond and mortgage and the guaranty of Prudence. Simultaneously with the assignment of the bond and mortgage by Prudence-Bonds Corporation, Prudence executed an agreement of guaranty and the bond and mortgage and the guaranty were deposited with the depositary. Certificates of participation in the mortgage were issued by Prudence-Bonds Corporation, authenticated by the deposi-

tary and turned over to Prudence who sold them to the general public.

With respect to the Zo-Gale Certificate Issue, Prudence on January 28, 1935, entered into a consolidation and extension agreement with Zo-Gale Realty Co. Inc., as owner of the premises subject to the said certificate issue, whereby mortgages aggregating the sum of $480,000 were consolidated and the time of payment of the principal sum was extended to April 1, 1935. By assignment dated January [fol. 23] 21, 1935, Prudence assigned the mortgages so consolidated and extended to Prudence-Bonds Corporation and entered into an agreement with Prudence-Bonds Corporation which provided that the interest of Prudence-Bonds Corporation in the consolidated mortgages was $450,000 and that such interest was senior to the interest owned by Prudence in the sum of $30,000. Thereafter the junior participation interest of $30,000 held by Prudence was paid in full. No deposit agreement was executed between Prudence-Bonds Corporation and Central Union Trust Company of New York. The sole agreement under which the depositary acted was a letter of transmittal dated February 3, 1925, addressed to Central Union Trust Company by Prudence-Bonds Corporation. A copy of said letter of transmittal is hereto annexed and marked Exhibit "A".

Attached to the petition herein as Exhibit "1" is a specimen certificate for this certificate issue issued by Prudence-Bonds Corporation, and guaranteed by Prudence, and as Exhibit "2", the instrument of guaranty executed by Prudence and deposited with the depositary. The certificate issued by Prudence-Bonds Corporation by its terms does not obligate Prudence-Bonds Corporation to make any payment with respect to the said bond and mortgage nor of the certificates. It constitutes merely an assignment of an undivided interest in the said mortgage to the purchaser.

On May 29, 1932, one Mary Walters, owner of certificate #B-2122 representing a $500 undivided interest in the Zo-Gale Certificate Issue, requested Prudence to reinvest the said sum of $500 in another certificate issue of Prudence-Bonds Corporation guaranteed by Prudence for $500. At the same time certificate #B-2132 for $300 registered in the name of Mary E. Field was reinvested together with other securities for $3,400 in the Fifth Avenue Hotel Certificate Issue. On October 26, 1932, Certificate #B-2891

for $16.67 was issued in the name of The Prudence Com- [fol. 24] pany, Inc. This certificate was acquired from credit which existed after many cancellations and authentications.

During the early part of 1933 Prudence negotiated with Reconstruction Finance Corporation for a loan of a substantial sum of money and presented to Reconstruction Finance Corporation a list of proposed collateral for such a loan. Included in the said collateral which was offered, was a new certificate, also guaranteed by Prudence, #B-2900 for $800 in the Zo-Gale Certificate Issue which was issued in the name of Reconstruction Finance Corporation in the place and stead of the aforementioned certificates #B-2122 and B-2132 which were then cancelled. On March 1, 1933, certificate #B-2891 was cancelled and certificate #B-2903, also guaranteed by Prudence, for $16.67 was issued in the name of Reconstruction Finance Corporation. Reconstruction Finance Corporation refused to accept this collateral for a further loan to Prudence and on April 4, 1933, the certificates #B-2900 and B-2903 were cancelled and new certificates #B-2908 for $800 and B-2909 for $16.67 were issued in the name of Prudence. At no time prior to the issuance of certificates #B-2908 and B-2909 were the certificates issued in the name of Prudence nor were such certificates at any time cancelled except upon the issuance of a certificate in substitution of such cancelled certificate. It was the intention in each instance upon the acquisition of the aforementioned certificates by Prudence, to hold such certificates as investments and the acquisition by Prudence was not intended at any time to constitute a cancellation or payment under its guaranty.

Moreover, as appears from the books and records of Prudence, such certificates were included in its assets listed on its published financial statements and its own balance sheets.

Certificates of participation were issued by Prudence-Bonds Corporation in the Zo-Gale Certificate Issue for the [fol. 25] full face amount of the mortgage with the exception of $7,200 which remained as a credit with the depositary which could be called upon by Prudence-Bonds Corporation to authenticate certificates in that amount.

On March 4, 1933, Prudence and other like corporations remained closed for several days pursuant to the proclamation issued by the Governor of the State of New York. At the end of the period of suspension of business neces-

sitated by the Banking Holiday, Prudence on March 16, 1933, resumed business subject to the Regulations issued to it by the Banking Board of the State of New York, and continued to operate under said Regulations at all times from March 3, 1933, to February 1, 1935, the date of the approval for its reorganization under Section 77B. Under the said Regulations of the said Banking Board, in order to avoid preferential expenditures of the funds of Prudence in favor of any creditors, Prudence was prohibited from making any payments out of its general assets to holders of Prudence certificates, either as principal or interest under its guaranty, or as advances for the protection of the property subject to the certificated mortgages. Payments to such holders of certificates and advances for the protection of the certificated mortgages were authorized only out of collections made by Prudence from the mortgagor on the mortgaged property. Under compulsion of such Regulations, Prudence defaulted in the payment of interest due on the Zo-Gale Certificate Issue on April 1, 1933. This was the first default on the guaranty of this issue. Therefore, upon the date of acquisition of the certificates above mentioned in the principal sum of $816.67, Prudence had fulfilled all of its obligations and no default existed with respect to this certificate issue.

In June, 1934, the petition for the reorganization of Prudence-Bonds Corporation under Section 77B of the Bankruptcy Act was approved by Hon. Robert A. Inch, United States District Judge for the Eastern District of New York, [fol. 26] and thereafter on February 1, 1935, the petitions for the reorganization of The Prudence Company, Inc. under Section 77B of the Bankruptcy Act were approved by Hon. Grover M. Moscowitz, United States District Judge for the Eastern District of New York. Upon the approval of the petition for the reorganization of Prudence, an order was entered by its Trustees fixing the procedure for the filing of proofs of claim against Prudence on its guaranty and other obligations. Similar provision was made with respect to claims to be filed against Prudence-Bonds Corporation by the Court in charge of that proceeding.

Thereafter proofs of claim were filed by individual certificate holders in the Zo-Gale Certificate Issue or on their behalf by the depositary in the proceedings for the reorganization of The Prudence Company, Inc., Debtor. In such proofs of claim certificate holders asserted their rights

against Prudence upon the guaranty of principal and interest due on the certificates held by said certificate holders, but in no instance did any certificate holder include in his proof a claim against any certificates or interests which Prudence or its Trustees held in the Zo-Gale Certificate Issue, nor to any priority in distributions on such interests. Attached hereto and marked Exhibit "B" is a copy of a typical proof of claim filed by the Zo-Gale certificate holders against Prudence in the proceedings for its reorganization.

On February 1, 1935, the Prudence Trustees on taking over the assets of The Prudence Company, Inc., Debtor, ascertained that included in the portfolio of assets of the Prudence Estate were bonds of Prudence-Bonds Corporation guaranteed by Prudence in the principal amount of $1,910,300. Claims were filed on such bonds in the proceedings for the reorganization of Prudence-Bonds Corporation and thereafter the question as to whether such bonds shared on a parity with the publicly held bonds was litigated in the United States District Court for the Eastern District of New York. After an adverse determination [fol. 27] against the Prudence Trustees by the Special Master to whom the question had been referred and by the District Court, efforts were made by both sides to compromise this issue and eliminate an appeal. The compromise agreed on by the Trustees of Prudence-Bonds Corporation and the Prudence Trustees and the creditors of both estates were submitted to both Judge Inch and Judge Moscowitz for approval. As part of the said compromise the Prudence Trustees were to withdraw claims filed against Prudence-Bonds Corporation and objections to the plan of reorganization which had been promulgated in that proceeding, and were to receive, in exchange, a cash payment of $150,000 together with all of the rights of Prudence-Bonds Corporation and its Trustees to the uncertificated portion of the various certificate issues, including the $7,200 uncertificated portion of the Zo-Gale Certificate Issue. This latter interest of Prudence-Bonds Corporation and its Trustees was to be transferred to the Prudence Trustees, subject, however, to all claims of general creditors of Prudence-Bonds Corporation and was acquired by the Prudence Trustees in the regular course of business. A copy of the petition and order entered approving the compromise are hereto annexed and marked Exhibit "C". Upon the entry of this order, the compromise was consummated in accordance

with its terms, and the $7,200 uncertificated portion of the Zo-Gale Certificate Issue was transferred to Prudence.

By reason of the default of the mortgagor, the holder of a second mortgage on the property subject to the Zo-Gale Certificate Issue foreclosed its mortgage and by arrangements made with Amalgamated Properties, Inc., a wholly owned subsidiary of Prudence, title was transferred to that corporation on February 1, 1933, by the second mortgagee at the termination of the foreclosure proceeding.

On March 16, 1936, the petition for the reorganization of Amalgamated Properties, Inc., a subsidiary of Prudence, was filed and approved by the United States District Court [fol. 28] for the Eastern District of New York. The order entered on the approval of the petition provided for the filing of individual claims by creditors of Amalgamated, including certificate holders, but further provided that claims filed in The Prudence Company, Inc., Debtor reorganization proceedings might be deemed filed in the Amalgamated proceeding and no further necessity existed for the filing of additional claims.

By order to show cause dated May 7, 1937, there was brought on for hearing before this Court in the proceeding for the reorganization of Amalgamated Properties, Inc., Debtor, a motion for the confirmation of the plan of reorganization for the Zo-Gale Certificate Issue which had been proposed by Amalgamated. After hearings held with respect to such plan and amendments and modifications made to it by the Debtor and by the creditors, the plan of reorganization as amended was finally approved by this Court and an order entered in the proceedings for the reorganization of Amalgamated confirming the plan and directing its confirmation. As heretofore set forth, individual proofs of claim filed by certificate holders against Prudence in the proceeding for the reorganization of that corporation, were deemed filed in the Amalgamated proceeding and any further claim filed by certificate holders on their own behalf with respect to the Zo-Gale Certificate Issue were in the same form. In neither proof of claim did any certificate holder assert a right against the certificates held by Prudence or its Trustees in the Zo-Gale Certificate Issue, being content solely to claim in the Prudence proceeding on the personal guaranty of that corporation, and in the Zo-Gale Certificate Issue, for the amount of the certificate holders' participating interest in the mortage.

As part of the plan of reorganization for the Zo-Gale Issue, discussion was had as to the disposition to be made of rights of the Prudence Trustees to participate on a parity with all other certificate holders in the distribution [fol. 29] of the estate represented by the Zo-Gale Certificate Issue. Such questions were left for future determination by provisions of the plan and the order of confirmation as set forth in detail in the petition herein. After the consummation of the plan, the Prudence Trustees received and thereafter assigned to Prudence Realization Corporation certificates representing the interest of the Prudence Trustees in the Zo-Gale Certificate Issue to the extent of issued certificates in the face amount of $816.67 and $7,200 representing the uncertificated portion of the mortgage. Each of these instruments indicated on its face that the question as to the right of distribution of the assets of the Zo-Gale Certificate Issue estate was to be left for future determination.

By order dated May 26, 1939, Hon. Grover M. Moscowitz, United States District Judge for the Eastern District of New York, approved and confirmed the plan of reorganization for Prudence which had been proposed and promulgated by Reconstruction Finance Corporation. A copy of the plan of reorganization and order of confirmation are hereto annexed and marked Exhibit "D". Under the provisions of the said plan of reorganization the rights of all creditors in the distribution of the Prudence Estate were determined. A formula was established for the determination of the final allowance of claims and no provision was made for priority to holders of the Zo-Gale certificates nor of any other certificates held by any other creditor where Prudence or its Trustees held certificates of participation in any certificate issues.

Deponent has been advised by counsel and verily believes that under the circumstances set forth in the petition and in this affidavit, there can be no question that the uncertificated portion of the Zo-Gale mortgage to the extent of $7,200 is held by Prudence Realization Corporation on a parity with the certificates held by the general public. It [fol. 30] must be conceded that in the event that the certificates had been held up to the present time by Prudence-Bonds Corporation, since it was not obligated on either the mortgage or to any person on a guaranty, they would be entitled to participate on a parity with the general

public. So much is clearly established by the law of the State of New York. Moreover, it is also clear under the decisions of the New York State Court that the acquisition of this uncertificated portion of the mortgage by the Prudence Trustees as part of a compromise subject to general claims against Prudence-Bonds Corporation constituted an assignment to the Prudence Trustees of the rights of Prudence-Bonds Corporation and in such capacity the Prudence Trustees acquired the status of their assignors. Under such circumstances, the respondent is entitled to a determination that it shares on a parity with other certificate holders to distributions in the Zo-Gale Issue to the extent, at least, of the $7,200 uncertificated portion of the mortgage.

With respect to the issued certificates in the face amount of $816.67, it is the position of respondent that these certificates were acquired by Prudence for its own corporate account as an investment with the intention that they be so held and not for the purpose of cancellation to extinguish its guaranty obligation. Deponent has been advised by counsel that the decisions in the New York Courts have indicated that where the intention to permit a guarantor to hold certificates on a parity with the general public to which it had assigned other certificates is not clearly set forth in the certificates themselves, the Court will apply an equitable rule authorizing distribution of the proceeds of an estate first to the assignee and next to the assignor. It is submitted that this is a rule of law adopted by the Courts of the State of New York, but not applicable to a bankruptcy proceeding which recognizes no such rule of distribution.

[fol. 31] It is to be noted that on February 1, 1935, the date of the approval of the Prudence petition for reorganization under Section 77B of the Bankruptcy Act, Prudence had already defaulted on its guaranty and any rights to priority in distribution which might at any time exist on behalf of certificate holders in the Zo-Gale Certificate Issue were then established. It is clear that the sole basis, upon which certificate holders may assert the right of priority in distribution from the Zo-Gale Certificate Issue against Prudence or its successor, is the failure of Prudence to fulfill its guaranty. It is the position of Prudence Realization Corporation that when the Zo-Gale certificate holders filed their proofs of claim against Prudence upon such

guaranty, such certificate holders were under an affirmative obligation to elect whether they would consider the participating interest held by Prudence in the Zo-Gale Certificate Issue as further and additional collateral for the performance of the Prudence guaranty to the Zo-Gale Certificate Holders or whether they would rely solely upon their distributive shares of the assets of the Prudence Estate based upon the full amount of their guaranty claim without calling for any priority.

By filing a proof of claim for the full amount of the guaranty obligation without giving credit to the Debtor for the value of the certificates or interest held by Prudence in the Zo-Gale Certificate Issue at that time, the certificate holders made an affirmative election to rely on their claims for the full amount of the guaranty. The remaining $133,000,000 of creditors of Prudence had the right at that time and still continue to have the right to assume that the Zo-Gale certificate holders would only share in the distribution of the assets of the Prudence Estate on their guaranty obligation without receiving in addition any priority in any of the assets constituting that estate. By now asserting a priority right in distributions made by the Zo-Gale Certificate Issue Trustee, certificate holders in that issue are asserting a right not alone to share on a parity with all other creditors in the assets of the Pru- [fol. 32] dence Estate to the extent of the unreduced amount of the guaranty, but in addition to their rights in the primary security (the mortgaged property), these certificate holders assert an affirmative right against that portion of the certificate issue which would ordinarily be distributable to and become part of the Prudence Estate. They are, by the present application, asserting that they hold either additional collateral for their guaranty to the extent of the Prudence interest in the issue, or a right to priority in distribution of the assets of the Prudence Estate as against all other creditors.

Deponent has been advised by counsel and verily believes that under the Bankruptcy Act a creditor who fails to list collateral for the debt in his proof of claim is an unsecured creditor, and is deemed to have waived his rights in the unlisted collateral; nor does it appear that a creditor may, after filing as a general unsecured creditor, assert priority rights. Deponent is advised that no facts exist in the instant case to take this case out of this general rule.

These certificate holders filed claims against Prudence as unsecured creditors. The mortgaged property, owned by a third person, did not constitute part of the Debtor's estate and therefore guaranty creditors were unsecured. However, when the certificate holders assert that in addition to their 381,983.33/390,000ths participating interest in the Zo-Gale mortgage, they may look to Prudence 8016.67/390,-000ths interest as collateral for the fulfillment of the Prudence guaranty, they are claiming rights as secured creditors of Prudence, since here the interest of Prudence is an asset of the estate and is properly within the definition of secured creditors. As heretofore noted, upon the election of certificate holders to file claims as unsecured creditors and not to consider the interest held by Prudence in the certificate issue as security for the guaranty, the certificate holders have waived their rights and may not presently assert them to the prejudice of other creditors. [fol. 33] Under the present application, certificate holders ask for preferential treatment which they neither sought nor provided for during the Prudence proceeding. To illustrate the legal situation, we may assume a certificate issue called "X issue", which consists of $200,000 of outstanding certificates of which $190,000 are held by the public and $10,000 by Prudence, where the property earns 2% on the mortgage and can be liquidated for $150,000.

The X certificate holders filed claims *on the Prudence guaranty* for $190,000 against Prudence. The assets of the Prudence Estate including the $10,000 certificates in the issue involved have a face value of $1,000,000, and the total claims including X certificate holders filed against Prudence total $25,000,000.

The X certificate holders now claim:

1. The 2% interest earned by Prudence's $10,000 X certificate shall be paid to them *on their guaranty* and shall not be included in a distributable assets of the estate;

2. Upon liquidation of the property subject to the X Certificate Issue for $150,000, instead of the Prudence Estate receiving its 1/20th interest in the proceeds, or $7,500, that sum shall be turned over to the X certificate holders as part payment *on account of the guaranty obligation* since they are receiving less than full payment out of the proceeds of the property;

3. They shall receive distributions from the Prudence Estate *on the full amount of their guaranty*, in the propor-

tion which their $190,000 claim bears to the total claims of $25,000,000 in assets having a face value of $990,000 ($1,000,000 less $10,000 X certificates).

The result of recognizing these claims is self-evident. By demanding these sums the X certificate holders consider that the $10,000 X certificates held by Prudence are either collateral for their guaranty obligation or that X [fol. 34] certificate holders are entitled to priority in any earnings of the certificates held by Prudence until the guaranty of the X issue is paid in full, without regard to the rights of other guaranty creditors. Not having asserted any such rights against Prudence in its 77B reorganization proceeding where the *guaranty* was reorganized, certificate holders may not now urge such rights after the acceptance and approval of the plan for the guarantor which granted no such extraordinary and additional rights.

The attention of the Court is respectfully called to the fact that the plan for the Zo-Gale Certificate Issue was consummated long prior to the confirmation of the Plan of Reorganization for Prudence. Amended proofs of claim in the Prudence proceeding could have been filed with the approval of the Court up to the time of the confirmation and consummation of the Prudence Plan. No attempts were made to file such amended claims either by such certificate holders or by the Trustee appointed in the certificate issue and your respondent is of the opinion that at the present time any rights which such certificate holders may at any time have had to insist upon priority in distributions in the Zo-Gale Certificate Issue, as against Prudence or its successor, no longer exist.

Wherefore, your respondent prays that the petition herein be in all respects denied and that an order be entered directing the petitioner herein, A. Joseph Geist, as Trustee of the Zo-Gale First Mortgage Participation Certificate Issue, to pay over to respondent all sums presently reserved by such Trustee with respect to the interest held by Prudence Realization Corporation in the Zo-Gale Certificate Issue, and that any distributions made hereafter on said certificate issue be distributed to Prudence Realization Corporation pro rata with other certificate holders.

William T. Cowin.

(Sworn to September 26, 1940.)

EXHIBIT "A" 13

February 3, 1925.
B&M #414

Central Union Trust Company,
80 Broadway,
New York City.

Attention: Mr. F. J. Fuller, Vice-President

Gentlemen:—

We are enclosing herewith for deposit with you the following papers:— 14

1—Bond of William T. Evans to the Union Dime Savings Bank dated March 5, 1913, in principal amount $390,000., on which there is now due $362,500., together with the mortgage given as collateral thereto.

2—Certified copy of assignment of the above bond and mortgage by Union Dime Savings Bank to The Prudence Company, Inc., dated January 29, 1925.

3—Bond of 202 Riverside Drive Corporation to Terrace Court Co., Inc., dated February 19, 1920, in principal amount $95,000., on which there is now due $47,500., together with the mortgage given as collateral thereto.

4—Assignment of the above bond and mortgage by Terrace Court Co., Inc. to Samuel A. Megeath, dated May 7, 1920. 15

5—Certified copy of assignment of the above bond and mortgage by Samuel A. Megeath to The Prudence Company, Inc. dated January 29, 1925.

16 *Exhibit "A".*

6—Bond of Zo-Gale Realty Co., Inc. to 202 Riverside Drive Corporation dated August 16, 1920 in principal amount $72,500. on which there is now due $49,000., together with the mortgage given as collateral to said bond.

7—Assignment of the above bond and mortgage by 202 Riverside Drive Corporation to Kentucky Holding Co., Inc., et al, dated December 21, 1920.

8—Certified copy of the assignment by Kentucky Holding Co., Inc., et al to The Prudence Company, Inc. dated January 27, 1925.

17 9—Bond of Zo-Gale Realty Co., Inc. to The Prudence Company, Inc. dated January 28, 1925, in principal amount $21,000. together with the certified copy of the mortgage given as collateral to said bond.

10—Certified copy of agreement between Zo-Gale Realty Co. Inc. and The Prudence Company, Inc., dated January 28, 1925 consolidating all of the above bonds and mortgages into one lien of $480,000. and extending the terms thereof.

11—Certified copy of an ownership agreement executed between The Prudence Company, Inc. as party of the first part and Prudence-Bonds Corporation as party of the second part, dated January 28, 1925 wherein Prudence-Bonds Corporation is given a prior interest of $450,000 in the lien of $480,000.
18

12—Certified copy of assignment of all the above bonds and mortgages by The Prudence Company, Inc. to Prudence-Bonds Corporation, dated January 28, 1925.

13—Guarantee of The Prudence Company, Inc. dated February 3, 1925.

14—Policy of Title Guarantee & Trust Company No. 925343 insuring the lien of said mortgaged premises.

15—Fire insurance binder covering the said mortgaged premises.

16—Appraisal of Realty Associates dated January 30, 1925 showing the value of the mortgaged premises to be 50% greater than the amount of certificates outstanding at any one time.

Will you kindly hold possession of these enclosures and from time to time certify Prudence First Mortgage Certificates delivered to you for certification against the said securities. These certificates will be in similar form to 20
those heretofore used by us in these transactions.

We understand that your fees in this matter will be upon the same scale as heretofore used in our matters.

Will you kindly acknowledge receipt of these papers by signing and returning to us the copy of this letter enclosed herewith for that purpose?

Yours very truly,

Prudence-Bonds Corporation
By:
F. T. Pender (signed)
Secretary.

FTP:DL

Feb. 6-1925 21

The above instruments duly received.

Central Union Trust Company of N. Y.
C. F. Carey (Signed)
Corporate Trust Department.

22

EXHIBIT "B"

UNITED STATES DISTRICT COURT

Eastern District of New York.

In the Matter of The Prudence Company, Inc., Debtor.	In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act. Nos. 27496 and 27028.

State of Pennsylvania }
23 County of Delaware } ss.:

On the 16th day of October 1935, came Alexander H. Bass of R. F. D. No. 3 of Media, in the State of Pennsylvania and made oath and says:

1. That this claim is made in deponent's own behalf.

3. That the claimant was on February 1, 1935, the date of the approval of the petitions for the reorganization of the Debtor herein, and still is, the lawful owner and holder of Pruden-e-Bonds Corporation mortgage participation certificate(s), and, if the same be not registered, of the coupons appurtenant thereto, which mortgage participation certificate(s) are described as follows:

24

Serial Number	*Interest Rate*	*Principal Amount*	*Name of Issue*
Ctfs B.2934/7	$5\frac{1}{2}$%	$40,000.00	Zo-Gale Realty Co. Inc.
B.2922/9	....	$........	....
	Total	$40,000.00	

Exhibit "B". 25

the bond(s) and mortgage(s) referred to in the said mortgage participation certificate(s) having been deposited with the Depositary or Depositaries therein mentioned; that in form, the Prudence Company, Inc. guaranteed payment of principal and interest as provided in an instrument executed by The Prudence Company, Inc. and deposited with the said Depositary or Depositaries; that the foregoing constitutes a statement of claimant's claim herein, and that the consideration therefor was the payment of moneys for the purchase of said mortgage participation certificate(s) by the claimant or claimant's predecessor in title.

4. Based upon the foregoing, a sum equal to the unpaid 26
principal of said mortgage participation certificate(s) and the interest thereon to February 1, 1935, now unpaid, is justly owing from the Debtor to the claimant; that there are no set-offs or counter-claims to the same, but the claim is subject to reduction by any payments received on account of principal and/or interest on said mortgage participation certificate(s) subsequent to the filing of this proof of claim; that upon said indebtedness no note or other evidence of indebtedness, except as aforesaid, has been received, and no judgment has been rendered thereon, and neither said claimant, nor to this deponent's knowledge and belief, has any person, by order of said claimant and to his use, had or received any manner of
security for said indebtedness, except to the extent that 27
the bond(s) and mortgage(s) deposited with the said Depositary or Depositaries as aforesaid, may be security for the said debt.

ALEXANDER H. BASS (L. S.)
(Signature)

Address to which all notices shall be sent:

R. F. D. #3 Media, Pa.

Subscribed and sworn to before me
this 16 day of October, 1935.

HELEN V. HARBOLD
Notary Public
My Commission Expires March 20, 1939

29

30

EXHIBIT "C" 31

UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF NEW YORK

IN THE MATTER OF THE PRUDENCE COMPANY, INC., Debtor. ——— In the Matter of the Application of the Trustees of the Debtor for an order approving a settlement and compromise of the claims of the estate of The Prudence Company, Inc. against Prudence-Bonds Corporation and its estate, and authorizing and directing the settlement and compromise of the same.	In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act. ——— Nos. 27496 and 27028.

32

Upon the annexed petition of Stephen Callaghan, John M. McGrath and William T. Cowin, Trustees of the Debtor herein, duly verified the 15th day of December, 1937, with the exhibits thereto attached and referred to therein and upon all the papers filed and the proceedings heretofore had herein,

LET, the Debtor herein, all parties and intervenors herein, all creditors and stockholders of The Prudence Company, Inc. and all other parties interested in the above entitled proceedings, or their respective attorneys or solicitors in the above entitled proceedings, show cause before me at a Stated Term of this Court to be held in Room 224 of the United States Court House, at the corner of Washington and Johnson Streets in the Borough of Brooklyn, City and State of New York on the 30th day of 33

December, 1937 at 2:00 o'clock in the afternoon of said day, or as soon thereafter as counsel can be heard, why an order should not be made and entered herein (a) approving an agreement of settlement embodied in Exhibits "A" and "B" annexed to the said petition; (b) authorizing and empowering the said petitioners as Trustees of the Debtor herein to carry out the said settlement agreement; and (c) authorizing and empowering the said petitioners as Trustees of the Debtor herein to do all acts necessary and to execute all papers, documents or other instruments in writing proper and necessary to carry out the said settlement agreement and (d) for such other and further relief as may be proper
35 in the premises.

Sufficient cause appearing therefor,

Let, service of this order and the petition upon which it is granted, by service of copies thereof on or before December 18th, 1937 upon the Debtor herein and upon all intervenors in this proceeding or their respective attorneys appearing herein and the Clerk of this Court, who shall forthwith give proper notice thereof to the Secretary of the Treasury of the United States, and by publication of a notice in substantially the form hereto annexed, marked "Exhibit A" once in the Brooklyn Daily Eagle and New York Evening Post, two (2) newspapers in general circulation in this district, on or before December 20, 1937, be deemed sufficient service upon and notice of this appli-
36 cation to, the Debtor, to all parties and intervenors herein, to the Secretary of the Treasury of the United States, to all creditors and stockholders of The Prudence Company, Inc. and to all parties and intervenors otherwise interested in the above entitled proceedings.

Dated: Brooklyn, New York
December 15, 1937.

Grover M. Moscowitz
U. S. D. J.

Exhibit "C". 37

EXHIBIT A

THE PRUDENCE COMPANY, INC., DEBTOR IN REORGANIZATION.

Notice to creditors, stockholders and all parties interested in the reorganization proceedings.

PLEASE TAKE NOTICE, that upon the petition of the undersigned and the order to show cause dated December , 1937 made thereon by the United States District Court for the Eastern District of New York in the proceedings pending in said Court entitled "In the Matter of The Prudence Company, Inc., Debtor, in proceedings for reorganization under Section 77B of the Bankruptcy Act, Numbers 27496 38
and 27028", a hearing will be held at said Court in Room 224 in the Federal Building, Washington and Johnson Streets, Brooklyn, New York, on , 1937 at 2:00 o'clock in the afternoon of said day, or as soon thereafter as counsel can be heard, why an order should not be made and entered in said proceedings authorizing and approving a settlement and compromise of certain claims of The Prudence Company, Inc., and of the undersigned as its Trustees, against Prudence-Bonds Corporation and its Estate including, among other things, a settlement of the litigation respecting the status of Prudence-Bonds owned by the undersigned and further including a settlement of other claims made on behalf of the Estate of The Prudence Company, Inc. in the proceedings for 39
reorganization of Prudence-Bonds Corporation and further including authority to the undersigned to execute consents to the plans of reorganization for the eighteen series of Prudence Bonds and to the amended general plan of reorganization and to authorize the undersigned to take all necessary steps and to execute all necessary documents, to carry out the aforesaid settlement agreement and to effectuate its substance and intent.

40 *Exhibit "C".*

The aforesaid hearing may be adjourned from time to time without further notice other than the announcement of the adjourned date at the hearing.

The petition upon which the aforesaid order to show cause was made, together with the agreement of settlement annexed to said petition, is on file in the office of the Clerk of said Court and copies thereof may be inspected by parties interested at the office of the undersigned.

Published by order of the Court.

Dated: December , 1937.

41 Stephen Callaghan, John M. McGrath and William T. Cowin, Trustees of The Prudence Company, Inc.,
331 Madison Avenue,
New York, N. Y.

42

Exhibit "C". 43

UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF NEW YORK.

IN THE MATTER

OF

THE PRUDENCE COMPANY, INC.,

Debtor.

In the Matter of the Application of the Trustees of the Debtor for an order approving a settlement and compromise of the claims of the estate of The Prudence Company, Inc. against Prudence-Bonds Corporation and its estate, and authorizing and directing the settlement and compromise of the same:

In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act. 44

Nos. 27496 and 27028.

PETITION

To the Honorable the Judges of the United States District Court for the Eastern District of New York:

The petition of Stephen Callaghan, John M. McGrath and William T. Cowin, as Trustees of the above-named Debtor, respectfully shows: 45

1. Your petitioners were appointed temporary trustees of The Prudence Company, Inc., Debtor, by an order made in the above entitled proceedings on February 1, 1935, and the appointment of your petitioners as such Trustees was made permanent by an order of this Court made on March 8, 1935. Your petitioners have duly qualified and are now

46 *Exhibit "C".*

acting as such Trustees of The Prudence Company, Inc., Debtor.

2. Your petitioners are informed and verily believe that prior to said February 1, 1935, Prudence-Bonds Corporation had issued and was obligor upon eighteen (18) separate issues of first mortgage collateral trust bonds, payable to the bearer or registered holder thereof, aggregating in principal amount approximately Fifty-six Million Dollars ($56,000,000); that each such bond issue is secured by a separate trust indenture made between Prudence-Bonds Corporation and a Bank or Trust company, under which
47 first mortgages and mortgage bonds and other securities were pledged by Prudence-Bonds Corporation, which securities constitute the collateral underlying said bond issues, and that the present names of the Trustees or successor Trustees of said eighteen (18) issues of bonds are as follows:

	Series A	Guaranty Trust Company of New York
	Series AA	City Bank Farmers Trust Company
	Third Series	City Bank Farmers Trust Company
	Fourth Series	City Bank Farmers Trust Company
48	Fifth Series	Bank of the Manhattan Company
	Sixth Series	Central Hanover Bank & Trust Company
	Seventh Series	City Bank Farmers Trust Company
	Eighth Series	Brooklyn Trust Company
	Ninth Series	Bank of the Manhattan Company

Exhibit "C". 49

Tenth Series	State Street Trust Company
Eleventh Series	Chicago Title and Trust Company
Twelfth Series	Manufacturers Trust Company
Thirteenth Series	Manufacturers Trust Company
Fourteenth Series	The Chase National Bank of the City of New York
Fifteenth Series	Chemical Bank and Trust Company
Sixteenth Series	The Marine Midland Trust Company of New York 50
Seventeenth Series	City Bank Farmers Trust Company
Eighteenth Series	Central Hanover Bank & Trust Company

3. Your petitioners are informed and verily believe that all of said Banks or Trust Companies have a principal office or place of business in the City and State of New York, with the exception of State Street Trust Company, which has its principal place of business in the City of Boston, State of Massachusetts, and Chicago Title and Trust Company, which has its principal place of business in the City of Chicago, State of Illinois.

51

4. Your petitioners are informed and verily believe that prior to February 1, 1935, The Prudence Company, Inc. had guaranteed the said bonds both as to principal and interest.

5. Your petitioners are informed and verily believe that prior to February 1, 1935, said Prudence-Bonds Corporation had issued and The Prudence Company, Inc. had

guaranteed both as to principal and interest fifty-four (54) mortgage certificate issues aggregating in principal amount approximately fifty-three million ($53,000,000) dollars; that each of such certificate issues represents participating certificates issued by Prudence-Bonds Corporation in a single bond and mortgage or a consolidated bond and mortgage on real estate; that Prudence-Bonds Corporation was not obligated on the said certificates.

6. Your petitioners are informed and verily believe that there are approximately thirty thousand holders of the outstanding bonds of the said eighteen (18) issues of bonds and that there are approximately twenty-three thousand
53 (23,000) holders of the outstanding certificates of the said fifty-four (54) certificate issues.

7. Your petitioners are informed and verily believe that on June 29, 1934, Prudence-Bonds Corporation filed its petition in this Court for reorganization under Section 77B of the Bankruptcy Act, and on the same day this Court entered its order approving said petition as properly filed under said Section 77B, and appointed Charles H. Kelby and Clifford S. Kelsey, as temporary trustees of Prudence-Bonds Corporation under that section, and by order entered on July 31, 1934, the appointment of said temporary trustees was made permanent by this court, and the said Charles H. Kelby and Clifford S. Kelsey duly
54 qualified and are now acting in that capacity.

8. Your petitioners are informed and verily believe that on February 1, 1935, the date of the approval of the petition for reorganization herein, and the appointment of your petitioners as Trustees of the Debtor herein, there were among the assets of The Prudence Company, Inc. and there came into the possession of your petitioners as Trus-

tees thereof, bonds of the said eighteen (18) series in the aggregate face amount of One Million Nine Hundred Ten Thousand Three Hundred ($1,910,300) Dollars.

9. Your petitioners are informed and verily believe that prior to the appointment of your petitioners as Trustees of the Debtor herein, Milton L. Masson, Special Deputy Superintendent of Banks, had filed or caused to be filed proofs of claim on behalf of the estate of The Prudence Company, Inc. in the proceedings for reorganization of Prudence-Bonds Corporation. Annexed hereto is a letter dated December 9, 1937, and marked Exhibit "A", which in paragraph "3" thereof contains a general description 56
of all such claims, and which claims are incorporated herein at this point as if set forth in full.

10. After the appointment of your petitioners as Trustees aforesaid, certain of the corporate trustees of the said eighteen (18) bond issues described in paragraph "2" hereof made distributions out of principal and/or income of the collateral in their possession as Trustee to owners and holders of bonds of the respective eighteen series, but wholly refused to pay over to your petitioners their pro rata share of such distributions with respect to the bonds of such issues owned and held by your petitioners as trustees aforesaid, and comprised in the bonds aggregating One Million Nine Hundred Ten Three Hundred ($1,910,300) Dollars, described in paragraph "8" hereof. Thereafter 57
and pursuant to leave granted by an order of this court made on January 20, 1936, your petitioners moved in the proceedings for the reorganization of Prudence-Bonds Corporation pending in this court, for an order directing the said corporate trustees to make the said distribution to your petitioners on account of said bonds owned and held by your petitioners, as aforesaid. The said corporate trustees, by their answers, raised the issue as to whether

58 *Exhibit "C".*

or not the bonds owned and held by your petitioners in the said eighteen (18) bond issues were entitled to parity of treatment with bonds held by the general public, the said corporate trustees contending that the said bonds were subordinate in all respects to other outstanding bonds of the said series.

11. Your petitioners are informed and verily believe that thereafter, the matter was referred by order of Hon. Robert A. Inch to James G. Moore, as Special Master, and there ensued extended hearings and lengthy testimony with respect to the said bonds. The said Special Master filed
59 two reports, one dated December 8, 1936, dealing with bonds of Series A, AA, Fourth, Sixth, and Eighteenth Series, and another dated April 28, 1937, dealing with the remainder of the thirteen series of Prudence-Bonds owned by your petitioners. The reports of the Special Master were in substance adverse to the claim of your petitioners for parity and equality of treatment and recommended that the said bonds be treated as subordinate. On July 21, 1937, in said proceedings for the reorganization of Prudence-Bonds Corporation, Honorable Robert A. Inch made an order approving the said Special Master's reports and adjudicating and holding that the Prudence Bonds of said eighteen (18) series owned and held by your petitioners are subordinate both as to principal and interest to all other bonds of the said eighteen issues owned by the
60 general public.

12. Your petitioners will offer to the court on the hearing of this application a copy of a record of all of the proceedings relating to the litigation of this question of the status of said One Million, Nine Hundred Ten Thousand Three Hundred ($1,910,300) Dollars of bonds. An appeal has been taken by your petitioners from the said order of July 21, 1937 and from the said determination

of the status of the bonds owned and held by your petitioners, but said appeal has not yet been argued or heard in the Circuit Court of Appeals for the Second Circuit to which the said appeal was taken.

13. Your petitioners are informed and verily believe that plans of reorganization for each of the eighteen bond issues of Prudence-Bonds Corporation were proposed by said Prudence-Bonds Corporation and by orders made in said Prudence-Bonds Corporation reorganization proceedings, this Court found that such plans had been duly proposed in accordance with Section 77B of the Bankruptcy Act. Thereafter, all said plans and all objections, modifications or amendments thereto were referred to James G. 62
Moore, Esq., as Special Master for consideration and report. Thereafter, hearings were held before said Special Master and the said Special Master filed reports approving, with certain modifications and amendments, separate plans of reorganization for all of the said eighteen series of bond issues. Said plans of reorganization, the reports thereon and the relevant orders of this Court with respect thereto are on file in the office of the Clerk of this Court, and are incorporated by reference at this point as if set forth in full. All of such plans in substance provide with respect to bonds of the eighteen series held by your petitioners that they shall be given the treatment to which they shall be legally entitled. Copies of said plans of reorganization will be offered to the Court at the hearing on this 63
application.

14. Your petitioners are informed and verily believe that Prudence-Bonds Corporation also proposed herein a general plan for the reorganization of its general assets and liabilities and by an order of this Court duly entered in the proceedings for the reorganization of Prudence-Bonds Corporation, the Court found that such plan had been prop-

erly proposed in accordance with section 77B of the Bankruptcy Act, and such plan and all objections or amendments thereto were also referred to Honorable James G. Moore, Esq., as Special Master for consideration and report with his opinion thereon.

15. Your petitioners are informed and verily believe that on or about March 11, 1937, said Special Master filed his report approving with certain modifications and amendments the said general plan of reorganization. That the Special Master in his report found that Prudence-Bonds Corporation is insolvent, and that in respect of each of the eighteen (18) separate issues of outstanding bonds of
65 Prudence-Bonds Corporation the present fair value of the collateral pledged to secure such issue is less than the principal amount of the outstanding bonds of such issue and accrued interest thereon, and that Prudence-Bonds Corporation, its stockholders and general creditors have no equity in said pledged collateral in any series of said bonds. Upon information and belief, such general plan of reorganization, as amended, contemplates the organization of a new corporation, which is to be owned and controlled exclusively by the bondholders of the eighteen series or creditors. By an order made in said proceedings for the reorganization of Prudence-Bonds Corporation on April 27, 1937, this Court found that Prudence-Bonds Corporation is insolvent, and tentatively approved the said amended general plan of
66 reorganization, subject to final confirmation in accordance with section 77B of the Bankruptcy Act. All of the foregoing reports and orders are incorporated by reference at this point as if set forth in full.

16. Your petitioners are informed and verily believe that the necessary acceptances from bondholders of each of the eighteen (18) series have been received by the Trustees of Prudence-Bonds Corporation and that applications

were made or are being made by said Trustees for confirmation of the said plans of reorganization for the said eighteen (18) series of bond issues, and for confirmation of the amended general plan of reorganization.

17. Your petitioners are informed and verily believe that the claims heretofore filed on behalf of The Prudence Company, Inc., and referred to in paragraph "10" hereof includes a claim by The Prudence Company, Inc. for advances aggregating Nine Hundred Eighty-seven Thousand Seven Hundred and Forty-three and 61/100 ($987,743.61) Dollars, which advances were made by The Prudence Company, Inc. for the protection of property or collateral securing the said eighteen (18) issues of Prudence-Bonds, 68
and for the payment of interest on such bonds. In addition said claims include the claim of The Prudence Company, Inc. to the ownership of "unissued certificates", i.e. the difference between the face amount of mortgages certificated in the said fifty-four (54) mortgage participation certificate issues, and the face amount of certificates actually issued and to "unissued bonds," i.e. bonds representing the difference between the face amount of collateral deposited in any one of the eighteen issues and the face amount of bonds actually outstanding.

18. Your petitioners are informed and verily believe that when motions were made to confirm the said plans of reorganization for the said eighteen (18) series of 69
Prudence-Bonds, and said amended general plan of reorganization, your petitioners caused answers, objections and exceptions to be filed in which your petitioners contended inter alia that the applications for confirmation of the plans were premature in view of the fact that there was pending the so-called "parity appeal" described in paragraph "13" hereof. Your petitioners urged that even if the said order of July 21, 1937, subordinating the bonds

of the eighteen (18) series owned by your petitioners, should be confirmed, that your petitioners would then as such subordinate bondholders constitute a separate class of creditors for whom no provision was made in the said plans of reorganization and whose consents were required.

19. Your petitioners further objected to the provisions of the amended general plan of reorganization upon the ground that any surplus that might arise in any bond issue should be applied first to the repayment of advances made by The Prudence Company, Inc., the nature of which is described in paragraph "16" hereof, before being applied
71 generally to other bond issues. The said motions to confirm the said plans of reorganization and the said amended plan of reorganization are still pending undetermined and no decision has been made on the answer, objections or exceptions of your petitioners.

20. Pending the said parity appeal and pending the said motions for confirmation, your petitioners and their solicitors entered into negotiations with Charles H. Kelby and Clifford S. Kelsey, and their solicitor, looking toward a settlement of these numerous claims and of the parity issue. The result of these negotiations is embodied in a letter of offer dated December 9, 1937, from your petitioners, a copy of which is annexed hereto and marked Exhibit "A", and acceptance thereof dated December 13, 1937, signed by
72 Charles H. Kelby and Clifford S. Kelsey, Trustees of Prudence-Bonds Corporation, accepting the said offer. A copy of the said letter of acceptance is annexed hereto and marked Exhibit "B".

21. Your petitioners believe that the said settlement is a desirable one and beneficial to the estate of The Prudence Company, Inc. and to its creditors (including bondholders of the eighteen series of Prudence-Bonds) and to all other persons interested in the estate of the Debtor.

22. Your petitioners believe that the effect of the settlement would be to give to your petitioners, first, the "unissued certificates" and any other interest of Prudence-Bonds Corporation in the said fifty-four (54) mortgage participation certificate issues, as between Prudence and Prudence-Bonds Corporation. A further effect will be to give to the estate of The Prudence Company, Inc. a sum approximating One Hundred and Fifty Thousand ($150,000) Dollars in cash. It will further make possible a speedier consummation of the plans of reorganization for the eighteen series of bond issues, by disposing of the necessity for taking and perfecting an appeal to the Circuit Court of Appeals on the "parity" issue. 74

23. Your petitioners believe that the claim respecting the Nine Hundred Eighty-seven Thousand Seven Hundred Forty-three and 61/100 ($987,743.61) Dollars, even though the same be a valid claim, has no possibility of immediate reduction and realization in actual cash. Under such circumstances it cannot be considered a substantial obstacle to a settlement which contemplates immediate receipt by your petitioners of approximately One Hundred Fifty Thousand (150,000) Dollars in cash. Your petitioners show, with respect to the surrender of the claim to unissued bonds (said claim being for $153,289.81, the face amount of such bonds), that apart from any consideration of the legal validity of the said claim (particularly in view of the
fact that both Prudence-Bonds Corporation and The Pru- 75
dence Company, Inc. are in default with respect to the said bond issues) such bonds even if received by your petitioners would occupy the same subordinate position in the event of the affirmance by the Circuit Court of Appeals as bonds already owned by your petitioners in the eighteen (18) series. Under such circumstances your petitioners believe that a settlement which contemplates the surrender of these claims in exchange for a present cash consideration will be advantageous to this Estate.

24. Your petitioners are desirous of enabling the approximately thirty thousand (30,000) holders of bonds of the eighteen (18) series, of whom more than sixty-six and two thirds (66-⅔%) per cent have expressed their approval of the Prudence-Bonds plans of reorganization, to consummate their reorganizations. By agreeing to this settlement your petitioners facilitate such consummation. Your petitioners believe that it will be to the best interests of the creditors of the Estate of the Debor herein to assist in the early consummation of the plans of reorganization of Prudence-Bonds Corporation. Your petitioners are also desirous of saving the estate of The Prudence Company,
77 Inc. the expense attendant upon the appeal on the parity issue, in which the decision of both the lower court and of the Special Master has been adverse to the claim of your petitioners.

25. Your petitioners do not believe that the withdrawal of the proofs of claim described in paragraphs "3" of Exhibit "A" and numbered therein II and VI, will result in any loss to this Estate. The proof of claim numbered II is a proof of claim having to do with Prudence-Bonds and/or mortgage participation certificates deposited as collateral by The Prudence Company, Inc. to secure The Prudence Company's 5-½% collateral trust bonds due May 1, 1961, and your petitioners are informed that Central Hanover Bank and Trust Company as corporate trustee
78 therefor has filed proofs of claim thereon. With respect to proof of claim numbered VI, your petitioners show that Prudence-Bonds Corporation was not obligor on Prudence certificates nor liable thereon, and that, therefore the surrender of this claim is not a surrender of a claim based upon any liability.

26. Your petitioners ask for an order to show cause in order that your petitioners may be instructed as to the

Exhibit "C". 79

method of service hereof, and in order that an expeditious hearing thereon may be had.

Wherefore, your petitioners respectfully pray that an order be made directing the Debtor herein, all intervenors herein, all creditors and stockholders of The Prudence Company, Inc., and all other parties interested herein, to show cause why an order should not be made approving the settlement agreement embodied in Exhibits "A" and "B" annexed hereto; authorizing and empowering your petitioners to carry out the said settlement agreement; and authorizing and empowering your petitioners to do all acts and to execute all papers, documents or other instruments 80
in writing proper and necessary to carry out the said settlement agreement.

Dated, New York, New York,
December 15, 1937.

Stephen Callaghan
John M. McGrath
William T. Cowin
Petitioners.

81

82 *Exhibit "C".*

State of New York }
County of New York } ss.:

Stephen Callaghan, being duly sworn, deposes and says that he is one of the petitioners named in the within petition; that he has read the said petition and knows the contents thereof; that the same is true of his own knowledge, except as to the matters therein stated to be alleged on information and belief, and that as to those matters he believes same to be true.

Stephen Callaghan

Sworn to before me this
15th day of December, 1937.

83 Richard J. Horrigan,
Notary Public
Kings Co. Clks. No. 457 Reg. No. 9169
N. Y. Co. Clerks No. 495, Reg. No. 9-H-349
Commission expires March 30, 1939

State of New York }
County of New York } ss.:

John M. McGrath, being duly sworn, deposes and says that he is one of the petitioners named in the within petition; that he has read the said petition and knows the contents thereof; that the same is true of his own knowledge, except as to the matters therein stated to be alleged on
84 information and belief, and that as to those matters he believes same to be true.

John M. McGrath

Sworn to before me this
15th day of December, 1937.

Richard J. Horrigan,
Notary Public
Kings Co. Clks. No. 457 Reg. No. 9169
N. Y. Co. Clerks No. 495, Reg. No. 9-H-349
Commission expires March 30, 1939

Exhibit "C". 85

State of New York }
County of New York } ss.:

William T. Cowin, being duly sworn, deposes and says that he is one of the petitioners named in the within petition; that he has read the said petition and knows the contents thereof; that the same is true of his own knowledge, except as to the matters therein stated to be alleged on information and belief, and that as to those matters he believes same to be true.

William T. Cowin

Sworn to before me this
15th day of December, 1937.

Richard J. Horrigan, 86
Notary Public
Kings Co. Clks. No. 457 Reg. No. 9169
N. Y. Co. Clerks No. 495, Reg. No. 9-H-349
Commission expires March 30, 1939

EXHIBIT A

December 9, 1937.

Charles H. Kelby and Clifford S. Kelsey, Esqs.
Trustees of Prudence-Bonds Corporation
331 Madison Avenue
New York, N.Y.

Dear Sirs: 87

Subject to the approval of the court having jurisdiction in the proceedings for the reorganization of Prudence-Bonds Corporation and subject to the approval of the court having jurisdiction over the proceedings for the reorganization of The Prudence Company, Inc., we propose the following:

(1) We will accept subordination of the Prudence-Bonds of the eighteen series owned and held by us as Trustees

88 *Exhibit "C".*

of The Prudence Company, Inc., in the aggregate principal face amount of $1,910,300.00 as subordination is defined in paragraph 11 of the several plans of reorganization for the eighteen series of bond issues and also as provided for and defined in the order of Hon. Robert A. Inch made on July 21, 1937. We will submit our bonds for stamping with an appropriate legend indicating such subordination.

(2) We will withdraw and discontinue the pending appeal from the order of Hon. Robert A. Inch made in the proceedings for the reorganization of Prudence-Bonds Corporation on July 21, 1937 and commonly referred to as "the
89 parity appeal".

(3) We will withdraw and consent to the expunging of all of the following proofs of claim heretofore filed by or on behalf of The Prudence Company, Inc. in the proceedings for the reorganization of Prudence-Bonds Corporation, and will release any and all of our rights, liens and interests with respect thereto against said Prudence-Bonds Corporation and its estate including its pledged collateral not specifically reserved herein, which claims are generally described as follows, to wit:

	General Nature of Claim	*Amount*
1.	Proof of claim verified November 30, 1934, by Milton L. Masson, Special Deputy Superintendent of Banks, being in substance a claim for (a) Guarantees of The Prudence Company, Inc. of Prudence bonds and Prudence certificates, and (b) The Constructive Trust Resulting Trust and all other rights, claims and equities in favor of The Prudence Company, Inc. against Prudence-Bonds Corporation.	No amount stated

90

Exhibit "C". 91

General Nature of Claim	*Amount*

II. Proof of claim verified November 30, 1934, by Milton L. Masson, Special Deputy Superintendent of Banks, being in substance a claim for 1961 Bonds and 1961 Trust Fund; proof of claim being filed (a) on behalf of The Prudence Company, Inc. in respect of the 1961 bonds owned by it and the surplus of (or residual right in) the 1961 Trust Fund, over and above the amount thereof required to liquidate all the 1961
bonds (whether owned by The Prudence 92
Company, Inc. or others), and (b) on behalf of all holders of 1961 bonds other than The Prudence Company, Inc., in respect of the 1961 bonds held by them and the lien thereof on the 1961 Trust Fund. — No amount stated

III. Proof of claim verified November 30, 1934, by Milton L. Masson, Special Deputy Superintendent of Banks, being in substance a claim for Prudence Bonds and Trust Funds; proof of claim being filed, (a) on behalf of The Prudence Company, Inc., in respect of
Prudence Bonds owned by it and sur- 93
plus of (or residual right in) the respective Trust Funds over and above the amounts thereof required to liquidate all the Prudence bonds (whether owned by The Prudence Company, Inc. or others) of the respective series of Prudence bonds, and (b) on behalf of all holders of Prudence bonds other than — No amount stated

94 *Exhibit "C".*

	General Nature of Claim	*Amount*
	The Prudence Company, Inc. in respect of the Prudence bonds and the lien thereof upon the respective Trust Funds.	
IV.	Proof of claim verified November 30, 1934, by Milton L. Masson, Special Deputy Superintendent of Banks, being in substance a claim for the rights and equities assigned to or reserved by The Prudence Company, Inc., under agreement of April 9, 1920.	No amount stated

95

V.	Proof of claim verified November 30, 1934, by Milton L. Masson, Special Deputy Superintendent of Banks, being in substance a claim for (a) sums advanced by The Prudence Company, Inc. for the protection of the Trust Funds and the mortgages, subject to the Certificate Issues, and (b) sums paid by The Prudence Company, Inc. under its guarantees of Prudence bonds and Prudence Certificates, and (c) all other rights arising upon said guarantees.	$1,512,788.52

96

VI.	Proof of claim verified November 30, 1934, by Milton L. Masson, Special Deputy Superintendent of Banks, being in substance a claim for Prudence certificates deposited by The Prudence Company, Inc. as security for certain guarantees of The Prudence Company, Inc. to Realty Associates Securities Corporation.	48,000.00

except in so far as any of the foregoing proofs of claim may constitute a claim in and to the uncertificated portions of certain certificated mortgages more fully described hereafter. Without limiting the generality of the foregoing, it is our intention to release any claim we may have to so-called "unissued bonds", i.e., bonds which might have been issued against an excess of collateral in any one of the eighteen bond issues over the then outstanding face amount of bonds previously issued, and it is our intention to withdraw any claim in and for such unissued bonds and any and all other claims not expressly reserved herein and all our rights, liens and interests with respect thereto against Prudence-Bonds Corporation and its estate includ- 98
ing its pledged collateral.

(4) We will execute consents to the pending plans of reorganization of the eighteen series of Prudence-Bonds which have been heretofore approved by the Special Master and to the amended general plan of reorganization dated March 24, 1937.

(5) We will withdraw any and all answers, exceptions or objections heretofore filed by us to the Debtor's amended plan of reorganization dated March 24, 1937, to the report of Hon. James G. Moore as Special Master thereon, dated March 11, 1937, as amended by letter dated March 24, 1937 from said Special Master to the court, and any and all objections or exceptions to the motions to confirm the 99
said report of the said Special Master or the said plan of reorganization.

(6) We will withdraw any and all answers, exceptions or objections heretofore filed by us or on our behalf to the motions to confirm the several plans of reorganization of the eighteen series of Prudence-Bonds which may have been made heretofore and any and all exceptions to the report

or reports of ~~Hon.~~ James G. Moore, with respect to such plans of reorganization.

(7) Our counsel will withdraw their petition heretofore filed for fees and allowances in connection with hearings on the "parity issue", and make no claim of any kind in the Seneca Issue of mortgage participation certificates or its plan of reorganization, and neither we nor our counsel will make any application or claim for fees and allowances in connection with any of the separate plans of reorganization of the eighteen series of Prudence-Bonds, the Seneca Issue of mortgage participation certificates, the amended general plan of reorganization, nor in connection with the
101 entire proceedings for the reorganization of Prudence-Bonds Corporation. We expressly reserve our claims on behalf of the Estate of The Prudence Company, Inc. for reimbursement of the cost and expenses of servicing and administering the collateral underlying the eighteen series of Prudence Bonds.

In return for all of the foregoing, we are to receive a sum equal to 50% of all moneys heretofore set aside, segregated or reserved at the time distribution or distributions were made to other holders of the said bonds, provided, however, that the aggregate of such sums to be paid to us shall not exceed the sum of $150,000., and we will release any and all claims which we may have to the balance of such segregated funds. The source from which said payment is to be made shall be subject to the order of the
102 Court in your proceedings.

(8) We are to receive any and all right, title and interest of Prudence-Bonds Corporation or yourselves in and to those certificated mortgages against which certificates have been issued by Prudence-Bonds Corporation and of which Prudence-Bonds Corporation is the owner and holder, or which Prudence-Bonds Corporation has deposited with a depositary for the issuance of Prudence mortgage par-

ticipation certificates, in so far as the said mortgages have not been certificated or in so far as no certificates have been issued against any portion of such mortgages. It is understood that the face amount of such uncertificated portions of such mortgages is $156,450.64. We are to receive the said uncertificated or unissued portions of the said mortgages subject to the claims of any general creditors of Prudence-Bonds Corporation.

(9) Nothing herein contained shall in any way affect or subordinate bonds of the eighteen series of Prudence-Bonds held by us as collateral for loans made by The Prudence Company, Inc. under the terms of collateral notes and which are held by us in pledge. 104

(10) You and we agree to execute any and all documents and papers necessary to effectuate any of the foregoing, including a general release in usual form to be executed by us releasing Prudence-Bonds Corporation and you of and from all claims, liens, rights or interests which we may now have and which are not specifically reserved herein.

Nothing herein contained or the execution or consummation of this agreement is in any way to affect, vary, impair or increase the rights of bondholders of the eighteen series of Prudence-Bonds with respect to the guarantee thereof made by The Prudence Company, Inc.

If the foregoing terms are acceptable to you, will you please acknowledge such acceptance by letter addressed 105
to us, referring to this letter and to the terms of the offer contained herein.

Very truly yours,

Stephen Callaghan
John M. McGrath
William T. Cowin
As Trustees of The Prudence
Company, Inc., Debtor.

JJF:PA

EXHIBIT B

December 13, 1937.

Stephen Callaghan, John M. McGrath
and William T. Cowin, Trustees of
The Prudence Company, Inc.,
331 Madison Avenue,
New York City, N. Y.

Dear Sirs:—

The undersigned ~~are~~ this day in receipt of your letter
107 dated December 9, 1937, setting forth the terms of an offer of settlement of the various claims, including Parity and other matters.

We accept the said offer, subject to the approval of the Court having jurisdiction in both of our proceedings.

Very truly yours,

Charles H. Kelby
Clifford S. Kelsey
Trustees of Prudence-Bonds Corporation.

108

Exhibit "C". 109

UNITED STATES DISTRICT COURT,

EASTERN DISTRICT OF NEW YORK.

IN THE MATTER
OF
THE PRUDENCE COMPANY, INC.,
Debtor.

In the Matter of the Application of the Trustees of the Debtor for an order approving a settlement and compromise of the claims of the estate of The Prudence Company, Inc. against Prudence-Bonds Corporation and its estate, and authorizing and directing the settlement and compromise of the same.

In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act. 110

Nos. 27496 and 27028.

A motion by an order to show cause signed by the Hon. Grover M. Moscowitz and dated December 15, 1937, upon the petition of Stephen Callaghan, John M. McGrath and William T. Cowin, duly verified the 15th day of December, 1937, with exhibits thereto attached, and upon all the papers filed and proceedings heretofore had herein, having duly come on to be heard before me on the 30th day of 111
December, 1937 for an order herein:

(a) Approving an agreement of settlement between the aforesaid Trustees of the Debtor and Charles H. Kelby and Clifford S. Kelsey, Trustees of Prudence-Bonds Corporation, Debtor; and

(b) Authorizing and empowering the said Trustees of the Debtor to carry out the said settlement agreement; and

(c) Authorizing and empowering the said Trustees of the Debtor herein to do all acts necessary and to execute all papers, documents or other instruments in writing proper and necessary to carry out the said settlement agreement; and

(d) For such other and further relief as might be proper in the premises;

Now, upon all the papers and proceedings heretofore had herein and upon reading and filing the said order to show cause and said petition of Stephen Callaghan, John M. McGrath and William T. Cowin, Trustees of the Debtor
113 herein, duly verified the 15th day of December, 1937, and exhibits thereto attached, with proof of due service thereof upon the necessary parties to this proceeding and proof of due publication of the notice to creditors and stockholders of the Debtor of said hearing, all as required by said order to show cause, and after hearing Thomas Cradock Hughes and Emanuel Celler (Samuel S. Allan, Esq., of counsel), solicitors for the Trustees of the Debtor, in support thereof, and no one appearing in opposition thereto, and due deliberation having been had thereon, it is

On motion of Thomas Cradock Hughes and Emanuel Celler, solicitors for the Trustees of the Debtor herein, hereby

114 Ordered, adjudged and decreed as follows:

(1) That by virtue of the due service of said order to show cause and petition, and due publication of the notice to creditors and stockholders of the Debtor, as above described, the Debtor and all persons interested in the Debtor, whether as creditors and stockholders or otherwise, are adequately represented in this proceeding, as required by law, so as to cause the decree herein to be binding upon each and every one of them;

(2) That the settlement and compromise of the claims of The Prudence Company, Inc. and its Trustees against Prudence-Bonds Corporation upon the terms and conditions set forth in the agreement of settlement annexed as an exhibit to said petition of the Trustees of the Debtor be and the same hereby is in all respects authorized and approved;

(3) The Trustees of the Debtor are hereby authorized and empowered to consent to the eighteen approved Plans of Reorganization for the eighteen series of bonds of Prudence-Bonds Corporation and to the approved Amended General Plan of Reorganization of Prudence-Bonds Corporation. 116

(4) The Trustees of the Debtor are hereby authorized and empowered to submit the bonds of the said eighteen series of Prudence-Bonds owned by said Trustees for stamping with an appropriate legend indicating that they are subordinate as provided for in the said eighteen Amended Plans of Reorganization and as defined by an order made by Hon. Robert A. Inch, a Judge of this Court, on July 21, 1937 in proceedings for the reorganization of Prudence-Bonds Corporation.

(5) The Trustees of the Debtor are authorized to withdraw and discontinue the appeal heretofore prosecuted by them from the said order of July 21, 1937 to the Circuit Court of Appeals for the Second Circuit.

117

(6) The said Trustees of the Debtor are hereby authorized and empowered to withdraw the proofs of claim and claims agreed to be withdrawn in said settlement agreement but only to the extent provided for in said settlement agreement.

(7) The Trustees of the Debtor are authorized and empowered to withdraw any answers, exceptions or objections heretofore filed by them or on their behalf to the eighteen

approved Plans of Reorganization of the eighteen series of Prudence-Bonds or to the respective Reports of Special Master James G. Moore, thereon, or to the motions to confirm said Plans and Reports or to the approved Amended Plan of Reorganization of Prudence-Bonds Corporation dated March 24, 1937, or to the Report of Hon. James G. Moore as Special Master thereon, or to the motion to confirm said Plan and Report.

(8) The said Trustees of the Debtor and their counsel, Thomas Cradock Hughes and Emanuel Celler, are authorized to withdraw their application for fees and allowances heretofore filed before Hon. James G. Moore as
119 Special Master in the proceedings for the reorganization of Prudence-Bonds Corporation, in connection with hearings to determine the status of Prudence-Bonds of the eighteen series of Prudence-Bonds Corporation owned and held by said Trustees of The Prudence Company, Inc.

(9) The said Trustees of the Debtor are authorized and directed upon the consummation of the settlement to turn over and pay to the respective corporate trustees of the eighteen issues of Prudence-Bonds any and all moneys heretofore set aside, reserved or segregated for distribution by said Trustees on account of the Prudence-Bonds of the said eighteen series owned by said Trustees, and to furnish to said corporate trustees and each of them any and all statements, accountings or information necessary
120 in connection therewith provided, however, that said Trustees shall receive the sum provided to be paid to them by said settlement.

(10) The said Trustees are further authorized to execute any further documents, releases or instruments and to do all things necessary and proper to perfect and carry out the terms of the said settlement agreement.

Dated: Brooklyn, New York, January 28th, 1938.

GROVER M. MOSCOWITZ,
U. S. D. J.

EXHIBIT "D" 121

United States District Court

Eastern District of New York

In the Matter

of

THE PRUDENCE COMPANY, Inc.,

Debtor. 122

In the Matter of the General Plan of Reorganization Proposed by Reconstruction Finance Corporation.

In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act.

Nos. 27496 and 27028.

123

ORDER, DATED MAY 26, 1939, RELATIVE TO AMENDMENTS, CONFIRMATION, CONSUMMATION AND OTHER MATTERS.

AMENDED

PLAN OF REORGANIZATION

for

THE PRUDENCE COMPANY, INC.

As Proposed by Reconstruction Finance Corporation, April 12, 1938, with Amendments, and as Confirmed by Order of the Court dated May 26, 1939.

In Consolidated Proceedings Nos. 27496 and 27028 in the District Court of the United States for the Eastern District of New York for the Reorganization of The Prudence Company, Inc., under Section 77B of the National Bankruptcy Act.

than in respect of capital stock) consist mainly of the amount due in respect of the note payable held by the RFC, and amounts due on guarantees of whole mortgages and of Prudence-Bonds Corporation secured bonds and mortgage participation certificates.

From information furnished by the Section 77B Trustee as at the confirmation of the Plan, the claims filed against the Debtor (after deduction for such thereof, including Federal income tax claims and New York State franchise tax claims, as have been withdrawn, released, settled or paid, or separately reorganized or finally disallowed in these proceedings, or ordered so to be, or as are payable out of segregated funds) may be summarized, approximately, as follows, including interest except as noted:

Nature of Claim	*Amount*
(1) Claim of the RFC..................................	$ 11,848,000 *
(2) Claims arising out of guarantees by the Debtor of obligations of others:	
(a) Guarantees of Prudence-Bonds Corporation secured bonds (excludes Debtor-owned bonds)	58,833,000 †
(b) Guarantees of Prudence-Bonds Corporation mortgage participation certificates (excludes Debtor-owned certificates)........	50,858,000 †
(c) Guarantees of whole mortgages............	12,523,000
(3) Miscellaneous claims..................................	151,000 ‡
Total..................................	$134,213,000 §

There being no feasible way of reorganizing the Debtor as a going concern with a continuing business, the object of the Plan is to facilitate the most advantageous realization of the assets and the most equitable distribution of their

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* Upon consummation of the Plan the RFC's claim is to stand allowed in the reduced amount of approximately $11,348,000—see Plan, Article IV, (3h).

† Excludes the 1111 Park Avenue, Park Place Dodge, 100 West 55th Street and Blind Brook issues (fully paid), and the Wortheo and Dryden issues (released).

‡ Excludes Manufacturers Trust Company's claim, settlement of which without payment out of the Debtor's general assets was pending before the Court when the Plan was confirmed.

§ Does not reflect the above mentioned reduction to be made in the RFC's claim.

proceeds to the creditors. As indicated above, the major portion of the claims against the Debtor arises out of guarantees of whole mortgages and of Prudence-Bonds Corporation secured bonds and mortgage participation certificates. Because of uncertainties in the real estate market it is impossible to tell at this time which bond and certificate issues and which whole mortgages may ultimately be paid in full (with or without a surplus) and which ones may result in a deficiency. It is also believed that the nature of the assets in the Debtor's estate is such that a substantial sacrifice of values would result if the assets were liquidated under the limitations and handicaps necessarily incident to bankruptcy proceedings.

In the light of these considerations, the Plan contemplates the reorganization of the Debtor so as to provide, through the medium of a business organization, for an orderly realization of assets and for a distribution of the proceeds in cash among the Participants in the Plan (as therein defined) in such manner as to take equitable account of the substantial variations in the extent to which they are secured.

With a view to the making of as large and immediate a cash payment as reasonably practicable to the main group of creditors other than the RFC, the Plan, as more fully set forth in Article IV thereof, provides that the RFC will forego, until the Final Distribution under the Plan, its share of the initial cash distribution, thus in effect advancing such cash, without interest, for distribution among the Secured Participants (as defined in Article I of the Plan), such Participants consisting chiefly of holders of claims based on the Debtor's guarantee of whole mortgages and of Prudence-Bonds Corporation secured bonds and mortgage participation certificates.

For the purpose of computing the amounts to be thus initially distributed to Secured Participants, such Participants are not required by the Plan to make any offset against the amount of their claims in respect of the value of the security held by them. As to subsequent distribu-

tions, the Plan provides in effect that in computing the amounts to be distributed, there shall be an offset against the Secured Participants' claims to the extent of the value (to be determined as provided in Article V of the Plan) of any security held for their claims (or for the obligations to which their claims relate) whether such security relates to property owned by the Debtor or a third party, an exception being made to the foregoing if such third party is a guarantor or surety for the Debtor,—this because the reduction of any claim against the Debtor by the amount realized against the guarantor or surety would merely give rise to a corresponding claim on his part against the Debtor.

From the inception of these proceedings up to July 6, 1937, the RFC was enjoined from realizing upon its security, and thereafter the RFC refrained from so doing pending negotiations with the Section 77B Trustees with a view to effecting a realization in such a way as to yield the maximum benefit to all creditors. As a result of these negotiations all of the collateral pledged by the Debtor with the RFC has been sold, under supervision of the Court, and pursuant to orders of the Court providing for certain minimum bids for substantially all of such collateral. The RFC was the sole and exclusive bidder for such collateral by virtue of its bids aggregating approximately $11,323,000. As a result of such sale the RFC is an Unsecured Participant under the Plan as therein defined, and will therefore share in the initial cash distribution only on the basis of its reduced claim, whereas the Secured Participants will share in such distribution without offsetting to any extent the value of their security.

The Judge in these proceedings having found by order dated April 25, 1938, that the Debtor is insolvent, the Plan makes no provision for the stockholders of the Debtor.

AMENDED PLAN OF REORGANIZATION
for
THE PRUDENCE COMPANY, INC.

ARTICLE I.

DEFINITIONS.

In this Plan the following terms have the following meanings unless otherwise expressly stated:

Debtor means The Prudence Company, Inc.

Section 77B means Section 77B of the National Bankruptcy Act, including all amendments to date.

Court means the United States District Court for the Eastern District of New York acting in the proceedings under Section 77B with respect to the Debtor.

Section 77B Trustee means the Trustee of the Debtor appointed by the Court.

Plan means this Plan of Reorganization.

Effective Date means the date as of which the Plan is consummated pursuant to the order of the Court.

Record Date means any record date fixed by the Court or otherwise as provided in the Plan, for any appropriate purpose of the Plan.

New Company means the new corporation in which the assets and business of the Debtor's estate are to be vested pursuant to Article III of the Plan.

Creditors means "creditors" as defined in Section 77B(b).

Claims means "claims" as defined in Section 77B(b).

Collateral means (1) the bonds and mortgages and other property, tangible or intangible, real or personal, held as security for any one of the eighteen separate bond issues of Prudence-Bonds Corporation guaranteed by the Debtor; (2) any bond and mortgage or other property, tangible or intangible, real or personal, in which certificates of participation have been issued by Prudence-Bonds Corporation and guaranteed by the Debtor, or any bond

and mortgage or other property, tangible or intangible, real or personal, securing any such certificates of participation or securing any bonds or certificates or other securities issued or received in exchange for or in lieu of such certificates of participation; (3) any whole single bond and mortgage or interest therein, guaranteed by the Debtor (other than bonds and mortgages, and interests therein, referred to in clauses (1) and (2) of this definition) or property, tangible or intangible, real or personal, acquired upon foreclosure thereof or by deed in lieu thereof or in exchange for such bond and mortgage, or interest therein, or for any such property, and in case of the sale of property so acquired, any purchase money bond and mortgage on such property taken back on such sale by the mortgagee.

Participant means a holder of a finally allowed claim against the Debtor upon which claim the Debtor is personally liable. Unless otherwise indicated by the context such term shall be deemed to include the assignee of a Participant claiming under a valid assignment in writing duly filed with the Section 77B Trustee or the New Company as the circumstances of the case may reasonably require.

Secured Participant means a Participant whose claim (or the obligation to which his claim relates) was secured on February 1, 1935, by either (a) Collateral, or (b) security other than Collateral (unless such other security consisted of property or an obligation of a guarantor of or surety for the Debtor in respect of such claim); provided, however, that no Participant who (or whose predecessor in interest) held, on February 1, 1935, security of the character referred to in the foregoing subdivision (b) which security, prior to the Effective Date, has been sold or realized upon in its entirety, shall be deemed a Secured Participant. No property acquired by a Participant (or his predecessor in interest) prior to February 1, 1935, through ~~the entire~~ foreclosure of a Single Mortgage, as hereinafter defined, shall be deemed to have been held on February 1, 1935, as security for such Participant's claim based upon

the guarantee by the Debtor of such Single Mortgage, and such Participant shall not be deemed a Secured Participant with respect to such claim. Each Prudence Bond Participant and Prudence Certificate Participant, as hereinafter respectively defined, shall be deemed a Secured Participant.

Unsecured Participant means a Participant who is not a Secured Participant.

RFC means Reconstruction Finance Corporation, its successors and assigns.

Prudence Bond means any bond issued by Prudence-Bonds Corporation and guaranteed by the Debtor.

Prudence Certificate means any certificate of participation in a bond and mortgage issued by Prudence-Bonds Corporation and guaranteed by the Debtor.

Single Mortgage means any bond and mortgage or interest therein guaranteed by the Debtor other than (a) any bond and mortgage in respect of which Prudence Certificates have been issued, or (b) any bond and mortgage constituting part of the Collateral securing any issue of Prudence Bonds.

Prudence Bond Participant means a Participant whose claim is based on the guarantee by the Debtor of a Prudence Bond.

Prudence Certificate Participant means a Participant whose claim is based on the guarantee by the Debtor of a Prudence Certificate or of a bond and mortgage as to which Prudence Certificates have been issued.

Reserved Right Participant means a person who, between February 1, 1935 and the Effective Date, disposed of his Prudence Bond or Prudence Certificate (or of an instrument representing a beneficial interest therein, such as, but not necessarily limited to, a Trustee's certificate) and who, by proof filed with the Clerk of the Court on or before July 15, 1939, establishes to the Court's satisfaction that, upon such disposition, he reserved to himself the rights against the Debtor based upon the Debtor's guarantee of such Prudence Bond or Prudence Certificate.

8

New Company's Register means the register to be kept by the New Company as provided in paragraph 3(e) of Article IV hereof.

Appraisers means the appraisers selected to value the Collateral and other security as provided in Article V hereof.

New Loan Value of a parcel of real estate means the amount of money which, in the sworn opinion of the Appraisers, on the basis of the appraised value of such real estate arrived at as provided in Article V hereof, would constitute at the Effective Date a reasonable new first mortgage loan on such real estate, at the rate of interest and upon the terms found by the Appraisers to be then current for such loans; provided, however, that unless all three Appraisers agree that such New Loan Value is less than two-thirds of such appraised value, such New Loan Value shall be fixed at not less than two-thirds of such appraised value.

The phrase *obligation to which a claim relates* or its substantial equivalent means the obligation, or interest therein, on which (or on the guarantee of which), such claim is based and shall be deemed to include any obligation or interest therein issued in lieu of, or in exchange for, such obligation or interest therein.

ARTICLE II.

Parties Not Affected by the Plan.

Creditors whose claims against the Debtor have, prior to the Effective Date, been paid in full, or expressly withdrawn, released or compromised, or expunged by order of the Court, are not affected by the Plan and the Plan makes no provision for them. These creditors include the holders of the Debtor's Guaranteed Collateral Trust 5½% Gold Bonds, due May 1, 1961, of the Debtor's First Mortgage Group Certificates, Series B, and of the so-called Worthco.

Dryden, 1111 Park Avenue, Park Place Dodge, 100 West 55th Street and Blind Brook issues of Prudence Certificates.

The assets of the Debtor which are subject to claims for which the Debtor is not personally liable are to be vested in the New Company subject to such claims; accordingly, no separate or additional provision is made in the Plan with respect to the holders of such claims and they are not affected by the Plan.

The Judge in these proceedings having found by order dated April 25, 1938, that the Debtor is insolvent, the stockholders of the Debtor are not affected by the Plan and the Plan makes no provision for them.

ARTICLE III.

The New Company.

On the Effective Date, or as soon thereafter as practicable, the business conducted at the time being by the Section 77B Trustee and all assets of whatever nature in the Debtor's estate shall be vested in a new corporation, to be formed for the purpose (i. e., the New Company) free and clear of all claims and interests of the Debtor, its stockholders and creditors, and others, except the following which shall remain outstanding:

(1) such tax or other finally allowed claims, if any, as the Court may determine to have priority, and the items provided for in Article VIII hereof,

(2) finally allowed claims against the property of the Debtor in respect of which the Debtor is not personally liable, and

(3) finally allowed claims of the character which shall entitle the holders thereof to be deemed Participants as defined in Article I hereof;

provided, however, that all causes of action or rights in the Debtor's estate against present or former officers or

directors of the Debtor, and against other parties arising out of or relating to the transactions giving rise to such causes of action or rights, shall remain in the Section 77B Trustee, subject to being vested in the New Company when so ordered by the Court; pending such order, such causes of action or rights shall be prosecuted or otherwise disposed of for the benefit of the New Company in such manner as the Section 77B Trustee, with the approval of the Court, shall determine. All expenses of such prosecution or other disposition shall be borne by the New Company, subject to order of the Court, and the net proceeds thereof shall be paid to the New Company.

As sole consideration for the vesting of such business and assets in the New Company as aforesaid, the New Company shall issue all of its authorized capital stock as hereinafter in this Article III more fully provided.

The claims referred to in the foregoing subdivision (2) shall be payable only out of the property against which they are claims.

The claims and items referred to in the foregoing subdivisions (1) and (3) shall be paid by the New Company, but only as follows:

The claims and items referred to in the foregoing subdivision (1) shall be paid in full in due course out of the New Company's assets. Such claims and items shall not constitute liens upon such assets, but shall have priority over all distribution to Participants under the Plan and over all liabilities incurred by the New Company; and the New Company shall be entitled to sell all or any part of such assets free and clear of any charge in respect of such claims and items.

The claims referred to in the foregoing subdivision (3) shall not constitute liens upon the New Company's assets, and the New Company shall be entitled to sell all or any part of such assets free and clear of any charge in respect of such claims; provided, however, that nothing herein contained shall be deemed to affect the lien, if any, to which any part of such assets was subject, immediately prior

to the vesting thereof in the New Company, in respect of any such claim. The claims referred to in such subdivision (3) shall be payable, without interest, only as provided in Article IV hereof and only to the extent that the New Company's assets shall be sufficient to pay them, after reserving from such assets $70 for the New Company's capital and $70 for its surplus, and after payment of or provision for (i) the claims and items referred to in the foregoing subdivision (1) and (ii) such liabilities as may be incurred by the New Company. Such surplus shall be available to pay for stock which may be purchased by the New Company under the options hereinafter in this Article III provided for.

The name of the New Company shall be "Prudence Realization Corporation" or such other name as the Court may approve. The New Company shall not engage directly or indirectly in any business other than the business of administering, conserving and realizing upon its assets in an orderly manner, and of conducting the "servicing" and any other business activities that (a) are vested in the New Company as herein provided, or (b) may be undertaken by the New Company, upon vote of its Board of Directors, with respect to Prudence Bonds, Prudence Certificates and Single Mortgages, or securities or mortgages or interests therein issued in exchange therefor, or in payment or part payment thereof, or in lieu thereof; provided, however, that the foregoing restrictions shall in no way impair or otherwise affect the validity or binding effect of any transaction within the scope of the purposes, objects and powers set forth in the New Company's certificate of incorporation or entered into by the New Company in the exercise of any power, right or privilege vested in it by law, and provided, further, that if any question shall otherwise arise as to whether any activity of the New Company exceeds such restrictions, the judgment of the Board of Directors, evidenced by a resolution thereof concurred in by directors of each class, shall be conclusive in the absence of a showing of bad faith.

Appropriate steps shall be taken for the incorporation of the New Company as a stock corporation under the laws of the State of New York, with an authorized capital stock consisting of seven shares of capital stock without par value, of which five shares shall be designated as Class A Stock and two shares as Class B Stock.

The entire authorized capital stock of the New Company shall be issued, and such stock, together with all dividends and distributions in respect thereof, shall be held and disposed of, as in this Article III and in Article IV set forth. No dividend or other distribution shall be paid or made upon or in respect of the New Company's capital stock until all Participants become Paid-Up Participants as defined in paragraph 3(a) of Article IV hereof, and each such share of stock shall be subject to repurchase by the New Company from the holder thereof upon vote of its Board of Directors concurred in by not less than five directors, including at least one Class B director.

The Board of Directors of the New Company shall consist of seven directors, of whom five shall be designated as Class A directors and two shall be designated as Class B directors. After the designation of the initial directors of the New Company as hereinafter provided, the Class A Stock shall be entitled to elect the Class A directors and the Class B Stock shall be entitled to elect the Class B directors. Cumulative voting shall be provided for so that each share of Class A Stock shall be entitled to elect one Class A director and each share of Class B Stock shall be entitled to elect one Class B director. Except as aforesaid, there shall be no distinction between the Class A Stock and the Class B Stock. With the unanimous approval of the directors then in office, the Board of Directors may provide for an Executive Committee of the Board. A majority of such Committee shall be Class A directors and one member thereof shall be a Class B director.

The initial directors shall be designated as follows:

(a) Four of the initial Class A directors shall be designated by the Court. On or before such date as the Court may determine, creditors (other than the RFC) may file with the Court written suggestions as to persons to act as such four Class A directors, but the Court shall be free to make each such designation without regard to whether the name of the person so designated has been so suggested.

(b) Each creditor holding a claim in respect of a Prudence Bond, Prudence Certificate or Single Mortgage shall be entitled to file with the Section 77B Trustee, at any time prior to the confirmation of the Plan or such earlier date as the Court may fix, his written nomination of the remaining Class A director. The person so nominated by the creditors holding in the aggregate the largest principal amount of such claims shall be deemed designated as such Class A director.

(c) The initial Class B directors shall be designated by the RFC.

The certificate of incorporation or the by-laws of the New Company shall provide, in effect, that to qualify as such from and after the Effective Date, directors shall be stockholders.

The entire capital stock of the New Company (to consist, as aforesaid, of five shares of Class A Stock and two shares of Class B Stock) shall be issued to the Section 77B Trustee acting on behalf of the Debtor, as sole consideration for and upon the transfer to and the vesting in the New Company of the business and assets of the Debtor's estate as above provided in this Article III. The Section 77B Trustee shall forthwith upon the issuance of said stock assign and transfer one share of Class A Stock to each of the five initial Class A directors and one share of Class B Stock to each of the two initial Class B directors. Upon the receipt of such stock and in consideration for the transfer and assignment thereof to him, each such person shall enter into a written agreement with the New

Company to the effect that he accepts the same for the purposes and subject to the restrictions of the Plan and subject to the option of the New Company to repurchase such share at any time upon the payment to him of the sum of $10.00, and that throughout his term of office he will continue to hold such share. Each such person shall also agree to and shall endorse the certificate for his share of stock in blank and deposit the same with the New Company as security for the performance of such agreement.

Beginning with the year following the Effective Date, annual meetings of the stockholders shall be held for the purpose of electing directors. Each holder of a share of Class A Stock shall be entitled, in his discretion, to vote such stock for the election of himself as a Class A director, and each holder of a share of Class B Stock shall be entitled, in his discretion, to vote such stock for the election of himself as a Class B director. The certificate of incorporation of the New Company shall provide, in effect, that if any vacancy shall occur in the office of a Class A director, his successor shall be elected by the remaining holders of the Class A Stock, and that if any vacancy shall occur in the office of a Class B director, his successor shall be elected by the remaining holder of the Class B Stock; provided, however, that if any such vacancy shall not be so filled within the thirty days following its occurrence, such vacancy may be filled by a majority vote of the holders of all the issued and outstanding stock of the New Company, without distinction between Class A Stock and Class B Stock and without cumulative voting. If the offices of both Class B directors shall be vacant at any one time, the RFC (or its assignee on the New Company's Register) shall be entitled, within the thirty days following the occurrence of the second vacancy, to nominate the persons to be elected as the succeeding Class B directors; and appropriate provision to this effect shall be made in the written agreements to be entered into between the New Company and the holders

of Class A Stock pursuant to the foregoing paragraph of this Article III.

If any director shall cease to be such, by virtue of his death, resignation, failure of re-election, or otherwise, the New Company shall exercise its option, hereinabove provided for, to purchase the share of stock of the New Company theretofore held by such director. In such event, or in the event that the New Company shall for any other reason have repurchased a share of stock from any director, as hereinabove provided, and his office shall have become vacant because of his resulting disqualification, the share of stock so acquired by the New Company shall be transferred to the person elected to fill such vacancy, against payment to the New Company of the sum of $10.00; and such person shall thereupon enter into a written agreement with the New Company with respect to such stock to the same effect as the agreement made by his predecessor with the New Company, and shall also agree to and shall endorse the certificate for such share in blank and deposit the same with the New Company as security for the performance of his said agreement.

Except as otherwise provided in the Plan, the Board of Directors of the New Company shall act by a majority vote of a quorum which shall consist of not less than four directors. Each director shall be entitled to compensation not exceeding $1200 per annum, but, by vote of the Board of Directors concurred in by at least one director of each class, additional compensation may be paid to any director for his services as an officer of the New Company or for other special services. The aggregate compensation paid to the principal officers of the New Company during the first year following the Effective Date shall not exceed an amount approved by the Court as fair and reasonable.

Within three months after the close of each fiscal year, the Board of Directors shall cause a certified public accountant or a firm of certified public accountants selected by it, to examine the books and records of the New Com-

pany, and to submit to the Board of Directors a report which shall include a financial statement with respect to the operations of the New Company and its distributions to Participants during such fiscal year, and a balance sheet as of the close of such fiscal year. The New Company shall keep such report on file, open to the inspection of any Participant during reasonable business hours.

Upon completion by the New Company of the realization of all its assets and the distribution in cash among the Participants of the net proceeds thereof as more fully provided in Article IV hereof, the Board of Directors of the New Company shall take such action as shall be appropriate to terminate the corporate existence of the New Company and to surrender and cancel all the stock of the New Company.

ARTICLE IV.

Disposition of the New Company's Assets.

1. *Initial Distribution of Cash.* As soon as practicable after the Effective Date, the cash vested in the New Company as provided in Article III hereof (over and above such amount as may be retained by the New Company, with the approval of the Court, for current expenses and for the claims and items referred to in subdivision (1) of Article III hereof) shall be distributed among the Participants *pro rata* subject to the conditions set forth in this Article IV; provided, however, that the amount of cash which the RFC would be entitled to receive upon such *pro rata* distribution shall be distributed among the Secured Participants, and provided further, that for the purpose of computing the amount of any distribution to be made under this paragraph 1 no offset shall be made against the amount of the claim of any Secured Participant in respect of the value of the Collateral or other security securing his claim or the obligation to which his claim relates.

2. *Realization of Assets and Subsequent Distributions to Participants.* The New Company shall proceed, as promptly as deemed advisable by its Board of Directors in the interests of the Participants, with an orderly realization of its assets and the eventual reduction thereof to cash.

From time to time and subject to the conditions hereinafter in this Article IV set forth, the New Company shall distribute such cash (after making payment of or appropriate provision for its expenses and liabilities) *pro rata* among the Participants until all the Participants become Paid-Up Participants as defined in paragraph 3(a) of this Article IV; provided, however, that

(i) no distribution shall be made, prior to the Final Distribution referred to in subdivision (iv) below, unless the cash available therefor shall amount to at least $250,000;

(ii) except as otherwise expressly provided for in clause *First* of subdivision (iv) below, each Participant, for the purpose of all distributions under this paragraph 2, shall be entitled to participate in the proportion that (a) his claim, minus the applicable deductions provided for below in this subdivision (ii), bears to (b) the total claims of all Participants, minus the aggregate of such deductions; the said deductions to be made from the claim of each Secured Participant for such purpose to consist of (1) the *pro rata* value (determined pursuant to Article V hereof) of all Collateral or other security securing his claim or the obligation to which his claim relates, plus (2) the *pro rata* share of the total amount of cash received or realized subsequent to February 1, 1935 (the date as of which the Court approved the Debtor's petition for reorganization) and prior to the Effective Date in respect of the principal amount or corpus of any Collateral or other security which, at any time during such period, secured his claim or the obligation to which his claim relates, such cash deduction to include, in case such obligation has been purchased by a sinking or retirement fund, the amount of cash paid

in respect of such principal amount or corpus upon such purchase; provided, however, that

(a) if, in the judgment of the Board of Directors, no definitive proration should be made of the value of the Collateral or other security for a particular certificate issue, due to uncertainty whether certificates of such issue held in the Debtor's estate on the Effective Date are on a parity with other certificates of such issue, the deduction to be made pursuant to the foregoing clause (1) shall be based in the first instance on the assumption that the certificates so held in the Debtor's estate are not entitled to parity, and an appropriate reserve shall be established by the New Company to provide for the additional distribution to be made to certificate holders of such issue if the Board of Directors shall be later satisfied that such parity exists; the Board of Directors being authorized to discontinue such reserve if and when satisfied that such parity does not exist;

(b) in determining whether or not any cash received or realized as specified in the foregoing clause (2) was in respect of principal, the New Company may rely upon the designation made, in connection with the payment thereof, by the payor or distributing agent, or if no designation was so made, then upon any designation made by an order of any court having jurisdiction in the premises or by the provisions of any applicable consummated plan of reorganization, or, in the absence of any such designation, upon the advice of counsel; and

(c) no cash shall be deemed to have been so received or realized, upon a foreclosure sale, by the owner of the lien foreclosed, or an interest therein, if and to the extent that his distributive share of the proceeds of such sale were applied by him in payment for the property sold or an interest therein;

(iii) prior to such Final Distribution, no distribution shall be made under this paragraph 2 unless after such distribution there will remain in the New Company assets which have, in the judgment of the Board of Directors (concurred in by directors of both

classes), a realizable cash value of at least twice (a) the amount of the RFC's share in the initial cash distribution which was distributed to the Secured Participants pursuant to paragraph 1 of this Article IV, plus (b) an amount sufficient to pay all expenses and liabilities of the New Company theretofore and thereafter to be incurred;

(iv) when the assets of the New Company have been reduced to such an extent that, due to the limitations of the foregoing subdivision (iii), no distribution other than the Final Distribution can be made, the New Company shall proceed as promptly as practicable with the realization of such assets, and from time to time as cash becomes available shall make distributions as follows, the last such distribution to include the amounts theretofore reserved by the New Company in respect of its capital and surplus (all distributions made under this subdivision (iv) being collectively designated as the Final Distribution):

First: To the RFC, until the RFC shall have received (from the Final Distribution) the same percentage on its claim as the Secured Participants shall theretofore have received under the Plan upon their respective unreduced claims from the initial distribution provided for in paragraph 1 of this Article IV;

Second: After making appropriate provision for the actual and estimated expenses and liabilities of the New Company theretofore and thereafter to be incurred, *pro rata* to all Participants, including the RFC.

If and when all Participants become Paid-Up Participants as defined in paragraph 3(a) of this Article IV, any remaining proceeds of the realization of the New Company's assets not required to meet its actual and estimated expenses and liabilities theretofore and thereafter to be incurred shall be distributed upon the New Company's stock; and the then directors of the New Company who, as stockholders, shall be entitled to receive the amount so distributed shall forthwith cause such amount to be dis-

tributed among the Participants in the manner and subject to the conditions provided in this paragraph 2 and in the following paragraph 3 of this Article IV.

3. *General Conditions Relative to Distributions.* The following shall apply to all distributions made pursuant to this Article IV:

(a) When from all sources (whether from the New Company or otherwise) the full amount of a Participant's claim, as finally allowed in these proceedings, shall have been realized in cash in respect of the obligation to which such claim relates (or in respect of any property acquired either in connection with the collection of such claim or obligation, or by deed in lieu of foreclosure, or in exchange for any such obligation or any property so acquired) such Participant shall be deemed a Paid-Up Participant and shall not be entitled to share further in any distribution under the Plan until all other Participants become Paid-Up Participants. Nothing in the Plan shall impose any duty on the directors of the New Company to inquire as to amounts so realized from sources other than the New Company; nor shall any director be liable, in the absence of bad faith, on account of any distribution or portion thereof made to anyone not entitled thereto. No Secured Participant shall be under any obligation to account to the New Company or to any other Participant or otherwise because the amounts paid to him and his predecessors in interest in accordance with the Plan, together with the *pro rata* share of amounts realized on the Collateral or other security securing the obligation to which his claim relates, are in excess of such claim.

(b) The Board of Directors of the New Company shall fix an appropriate Record Date with respect to each distribution.

(c) Distributions payable to Prudence Bond Participants and to Prudence Certificate Participants shall be

made (1) to Reserved Right Participants registered as such on the New Company's Register pursuant to subdivision (e) of this paragraph 3; (2) to Prudence Bond Participants and Prudence Certificate Participants, other than Reserved Right Participants and those referred to in subdivision (d) below, as follows:

(i) to the persons whose names are certified to the New Company by the custodian of the register of the particular issue or series, as the case may be, as the registered holders thereof (or of instruments representing beneficial interests therein, such as, but not necessarily limited to Trustees' certificates) at the close of business on the applicable Record Date, excluding bonds or certificates, if any, in respect of which distributions are to be made to Reserved Right Participants; such distributions to be made by checks drawn to the order of such persons and mailed to them at their addresses as certified by the custodian of the appropriate register, or delivered to them in person;

(ii) to the custodian of the sinking or retirement fund of the particular issue or series as the case may be, in respect of bonds or certificates certified by such custodian to have been purchased by such fund, excluding bonds or certificates, if any, in respect of which distributions are to be made to Reserved Right Participants; and

(iii) in the case of Prudence Bonds or Prudence Certificates as to which no such certification is given (excluding bonds or certificates, if any, in respect of which distributions are to be made to Reserved Right Participants), distributions shall be made to the persons presenting the same for notation of the making of such distributions.

The New Company shall be fully protected and discharged from all responsibility with respect to all distributions made as in this subdivision (c) provided.

(d) Distributions payable to Prudence Certificate Participants (other than Reserved Right Participants) in respect of guarantee claims on any issue of Prudence Certificates for which no register (other than the New Company's Register) is being maintained for the recordation of current transfers (such as, but not necessarily limited to, the so-called Hotel Taft and Langham issues) shall be made, in the first instance, to such persons as shall present such Certificates to the New Company for registration as provided below or as shall submit to the New Company proof satisfactory to it of their ownership of such Certificates. The New Company shall register as a Participant, in respect of the guarantee claim on any such Certificate, the person first presenting such Certificate or such proof as aforesaid, and thereafter distributions in respect of such claim shall be made to such Participant or his registered assignee as provided in the following subdivision (e). The New Company shall be fully protected and discharged from all responsibility with respect to all distributions made as in this subdivision (d) provided.

(e) The New Company shall keep a Register of the names and addresses of all Participants, except Prudence Bond Participants and Prudence Certificate Participants to whom distributions are to be made as provided in clause (2) of the foregoing subdivision (c) of this paragraph 3. The Section 77B Trustee shall prepare and deliver to the New Company a list, as of the Effective Date, of all Participants (except Prudence Bond Participants and Prudence Certificate Participants) showing, in the case of each such Participant, his name and address, and the nature and amount of his claim or claims; and such list shall constitute the New Company's Register as of the Effective Date. The New Company shall be protected in all respects in relying upon such list as correct as of the Effective Date.

Upon receipt by the New Company of an appropriate written assignment, duly executed and acknowledged by a person registered as a Participant in the New Company's Register and specifying the name and address of such assignee (or, in the New Company's discretion, upon receipt of such other evidence of assignment as shall be satisfactory to the New Company), the name and address of such Participant shall be stricken from the New Company's Register and the name and address of his assignee substituted. Unless and until the New Company shall have received a written assignment as aforesaid by a person registered as a Participant in the New Company's Register (or, if the New Company, in its discretion, shall consent to accept other evidence of assignment, unless and until the fact of such assignment shall have been recorded in the New Company's Register), the New Company shall not be affected by notice of any assignment by such person and shall be protected in all respects in treating such person as a Participant, notwithstanding such an assignment or the receipt of notice thereof by the New Company.

Distributions payable to Participants registered as such in the New Company's Register shall be made to such Participants of record at the close of business on the appropriate Record Date, by checks drawn to their order and mailed to them at their addresses as shown in the New Company's Register, or delivered to them in person. The New Company shall be fully protected and discharged from all responsibility with respect to all distributions made as in this subdivision (e) provided.

(f) The New Company, upon notice to the Participants affected, may deposit any amount distributable under the Plan in a bank or trust company which is a member of the New York Clearing House Association (or, if the New Company shall so elect, in the case of Prudence Bond Participants and Prudence Certificate Participants, with the custodian of the register of the particular issue or series) as a trust fund for the benefit of such Participants, with

appropriate instructions as to the disbursement of such amount, such action to fully protect the New Company and discharge it from all responsibility with respect to such distribution.

(g) The realization of the New Company's assets and the reduction thereof to cash to be made pursuant to this Article IV shall be completed, and all distributions under the Plan to Participants shall be made, within five years from the Effective Date; provided, however,

(1) that if so determined by vote of the Board of Directors (concurred in by directors of both classes) the New Company, at least one hundred and eighty days prior to the termination of such five-year period, may give notice to the Participants (by publication or otherwise in such manner as the Board of Directors by such vote may specify) that in the judgment of the New Company it would be in the interests of the Participants to continue the activities of the New Company, for the purposes of the Plan, for a further specified period not exceeding an additional five years (subject to earlier termination by majority vote of the whole Board of Directors): and

(2) that in case such notice is so given the New Company's activities shall be so continued (i) if prior to the expiration of ninety days from the giving of such notice, a majority in amount of the Participants shall not have filed written objection thereto, or (ii) in case affirmative approval of such continuation is legally required, then if such affirmative approval shall have been effectively given within such ninety-day period.

(h) The RFC's claim as a Participant shall be allowed in the amount of $11,347,775.50, without prejudice to such right as the RFC may have, under the provisions of Section 77B(c)(9), or other applicable provisions of law, to be compensated for services rendered and to be reimbursed for expenses incurred in connection with the proceedings and the Plan.

(i) Unless prior to the Effective Date his claim (1) shall have been expressly withdrawn, released or compromised, or (2) shall have been expunged by order of the Court, no action taken subsequent to February 1, 1935, by or on behalf of any holder of a guarantee claim against the Debtor with respect to his Collateral, shall bar any such claimant from participating in the benefits of the Plan to the extent herein provided.

ARTICLE V.

Valuation of Collateral and Other Security.

For the purposes of the distributions provided for in paragraph 2 of Article IV of the Plan, the Collateral or other security securing, on the Effective Date, the claim of any Secured Participant or the obligation to which such claim relates, shall be valued (in accordance with the limitations hereinafter in this Article V prescribed) at the reasonable value thereof as at the Effective Date by three salaried individual Appraisers to be employed by the New Company, each of whom shall be a real estate appraiser of recognized standing or a Professional Engineer within the meaning of Article 55 of the Education Law of the State of New York.

The Appraisers shall be selected in the manner hereinafter set forth and shall be controlled in the making of such valuations by the following limitations:

(a) In any case in which the Collateral or other security shall include a mortgage upon real estate, the value of the mortgage shall be deemed to be the New Loan Value of such real estate less the amount owing on any liens or encumbrances which are senior to the lien of such mortgage;

(b) In any case in which the Collateral or other security shall include real estate, the value of such real estate shall be deemed to be the New Loan Value of such real estate less the amount owing on any liens or encumbrances thereon;

(c) In determining the value of the bond secured by any mortgage or the value of any other obligation to be valued under the Plan, the Appraisers shall take into consideration the reasonable probability of collecting thereon under any then existing laws and the probable cost of effecting such collection, and shall estimate as nearly as practicable the net amount which might be reasonably realized therefrom.

The Appraisers shall in each case furnish a report to the New Company in the form of an affidavit of appraisal, which shall be deemed to be made in these proceedings, which shall set forth the pertinent facts and circumstances upon which the appraisal is based, including the appraised value of the real estate as of the Effective Date in every case where the Collateral or other security shall include or consist of real estate or a mortgage upon real estate. Whenever the appraised value of real estate is set forth in an affidavit there shall also be included a statement that in arriving at such valuation the Appraisers have taken into consideration, among other elements, the earnings of such real estate, the land value, the value of any improvements thereon, the replacement costs of such improvements, recent sales of real property, if any, in the vicinity, the assessed value of the property, the type of improvement and present demand for space of such a character, the adequacy of the improvement, depreciation, obsolescence, neighborhood trends, the general condition of the improvement, the cost of making necessary repairs and of modernization if any be required, the amount of real estate taxes to which the property is subject, the cost of operation, if a hotel the general character of its management, and all other factors which in the opinion of the Appraisers have a bearing upon such valuation.

The Appraisers shall act by a majority vote, but if no two of their opinions shall agree with respect to an appraisal or a New Loan Value, then (subject to the proviso hereinabove contained in the definition of New Loan Value) the appraisal or New Loan Value, as the case may

be, shall be the average of the amounts fixed therefor by each Appraiser.

All valuations (a) shall be made and submitted in writing to the Court within six months from the Effective Date unless the Court, for cause shown, shall extend such period; (b) shall be noticed to such creditors and in such manner (by publication, mail or otherwise) as the Court may determine; and (c) in the case of the valuation of each item, shall become final for all purposes of the Plan unless, within such time as the Court may fix, written objections to such valuation shall be filed with the Court by not less than 10% in amount of the Secured Participants secured by such item, or by the duly authorized trustee or other representative of such amount of Secured Participants, or by not less than 10% in amount of the Unsecured Participants. In the event of the filing of any such objection as aforesaid, the same shall be brought on for hearing before the Court by the New Company in accordance with such procedure as the Court shall specify, and the determination of the Court as to such objection shall be final, without appeal by any party to any court of appellate jurisdiction.

Each Appraiser shall serve for such salary as shall be specified by the Board of Directors of the New Company and shall be selected in the following manner: one by the majority vote of the Class A directors; one by the Class B directors; and one by the concurring vote of (a) a majority of the Class A directors, and (b) the two Class B directors. All three selections shall be made within fifteen days after the Effective Date and shall be submitted forthwith to the Court and be subject to its approval. If (i) the selection of an Appraiser shall not have been so made and submitted by the directors, or (ii) the Court shall have disapproved a selection and no substitute selection shall have been made by the directors within fifteen days after such disapproval, a vacancy shall be deemed to exist which shall be filled by designation of the Court from a panel of names of appraisers which the directors of the New Company, severally or jointly, shall submit to the Court.

In the event that any Appraiser shall resign, die or become incapable of acting, a successor shall be appointed in the same manner as provided for the appointment of his predecessor. The salaries of the Appraisers and all other expenses incidental to their work shall be paid by the New Company.

ARTICLE VI.

Acceptance of the Plan.

The Plan makes no separate provision for creditors who do not accept it, but treats both assenting and dissenting creditors alike. Accordingly the Plan shall not become operative or be confirmed by the Court unless duly accepted by or on behalf of creditors holding two-thirds in amount of the claims of each class whose claims have been allowed and would be affected by the Plan.

ARTICLE VII.

Tax Claims of the United States of America.*

The United States Collector of Internal Revenue has filed claims for income taxes in these proceedings against the Debtor. Such tax claims shall have the same priority and preference, if any, and the same remedies shall exist for their collection, as if the proceedings for the reorganization of the Debtor had not intervened. All statutes of limitation upon the collection of such tax claims shall be suspended during the time the proceedings for the reorganization of the Debtor are pending and, if such tax claims shall be adjudged to be a lien upon, or to be entitled to priority or preference with respect to, the assets of the Debtor, for such additional period of time as such claim or any part thereof remains unpaid. Subject to its approval the Court shall retain jurisdiction over the assets

* After the proposal of the Plan, such claims in respect of all taxable periods prior to January 1, 1937, were compromised pursuant to the Court's order of May 5, 1938, and payment in full has been made of the compromised claims. In addition, the Federal tax return for the calendar year 1937 has been audited and no tax found due.

of the Debtor (including the assets to be vested in the New Company pursuant to Article III hereof) and over all parties appearing in the proceedings for the reorganization of the Debtor for the purpose of carrying out and giving effect to any and all provisions of the Plan and the decree confirming the same, in so far as the Plan as so confirmed affects and applies to such tax claims.

ARTICLE VIII.

Expenses of the Proceedings and the Plan.

Payment shall be made, as provided in Article III hereof, of (1) the expenses of the proceedings and the Plan, as approved by the Court, including all costs of administration and other allowances made or to be made by the Court to such parties as the Court may deem entitled thereto under the provisions of Section 77B, and (2) all Federal taxes, if any, due from the Section 77B Trustee, in respect of the period between December 31, 1937 and the Effective Date, whether or not a claim for such taxes shall have been filed or allowed by the Court.

ARTICLE IX.

Execution of the Plan.

As soon as practicable after the confirmation of the Plan by final order of the Court, the Plan shall be consummated by the vesting in the New Company of the business and assets required to be so vested by the provisions of Article III hereof and the issuance of the entire authorized capital stock of the New Company as provided in such Article III. Such final order shall contain all appropriate provisions in aid of the consummation of the Plan and to compel all necessary parties to comply therewith and to make, execute and deliver any instruments necessary to such consummation. All proceedings to be taken and instruments to be executed in the consummation of the Plan, including, without limita-

tion, the certificate of incorporation and the by-laws of the New Company, shall be subject, in the discretion of the Court, to its approval.

ARTICLE X.

Miscellaneous.

Subject to the provisions of Article V hereof, notices under the Plan to Participants and to other parties in interest, if any, may be given by publication once in each week for two successive weeks in a daily newspaper of general circulation in the City of New York.

The statements and figures contained in the Plan and in the Introductory Statement preceding the Plan have been derived from sources believed to be reliable, but none of them is to be construed as a warranty or representation.

In respect of any action taken to carry out any provision of the Plan and involving a legal question, the directors, officers, employees and agents of the New Company shall be protected, in the absence of a showing of bad faith, in relying upon the advice of its counsel.

No portion of any of the headings to the numbered Articles or paragraphs of the Plan nor any footnote therein shall be a part of the Plan or affect the meaning of any of the provisions thereof.

Dated, April 12, 1938.

Reconstruction Finance Corporation,
By Jerome Thralls,
Special Representative.

The Hecla Press : : New York City

United States District Court

EASTERN DISTRICT OF NEW YORK.

IN THE MATTER OF THE PRUDENCE COMPANY, INC., Debtor. In the Matter of the General Plan of Reorganization proposed by Reconstruction Finance Corporation.	In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act, — Nos. 27496 and 27028.

This Court having heretofore entered an order, dated August 16, 1935, ordering, adjudging and decreeing as to the manner, among other things, in which claims and interests of creditors in this proceeding should be filed or evidenced for the purposes therein set forth, including participation in any plan of reorganization which might be confirmed herein; and

Reconstruction Finance Corporation (hereinafter called the RFC) having heretofore filed its petition, verified April 12, 1938, proposing a Plan of Reorganization for the Debtor herein, dated April 12, 1938 (hereinafter called the Plan), and this Court by order to show cause dated April 13, 1938, having directed that the parties and interveners herein and all other persons interested as creditors, stockholders, or otherwise, and the Section 77B Trustees of the Debtor, show cause at a term of this Court on April 21, 1938, why an order should not be made adjudging the Plan to have been duly proposed, classifying the creditors as therein set forth, adjudging the Plan to be fair, equitable, non-discriminatory and feasible ~~and~~ to comply with Section 77B of the Bankruptcy Act, and confirming the

Plan; and numerous sessions of the hearing on said petition and order to show cause having been had; and such hearing having been adjourned from time to time by written order of this Court or by orders made in open court; and

The RFC having heretofore proposed certain amendments to the Plan, under date of June 17, 1938, and July 22, 1938, respectively, and this Court, by order dated August 3, 1938, having adjudged, among other things, that the Plan, amended as so proposed by the RFC, was fair and equitable and did not discriminate unfairly in favor of any class of creditors or stockholders and was feasible; and

The RFC having filed its further petition, verified May 5, 1939 (hereinafter sometimes referred to as the Petition for Confirmation), and this Court, by order to show cause dated May 5, 1939, having duly directed that cause be shown at a term of this Court on May 19, 1939, why an order should not be made, as contemplated by the Petition for Confirmation, which shall, among other things, (a) provide how and to whom distributions shall be made under the amended Plan; (b) amend, to the extent required to give effect to such provisions, the previous orders of this Court herein, including the aforesaid order dated August 16, 1935; (c) approve all amendments proposed by the RFC to the Plan, including those proposed in the Petition for Confirmation; (d) confirm the Plan as amended; and (e) direct the Section 77B Trustee of the Debtor to vest forthwith in the New Company provided for in the amended Plan the assets and business thereby required to be so vested, free and clear, except as provided in the amended Plan, of all claims and interests of the Debtor, its stockholders and creditors, and others, and further, to transfer to such New Company, subject to all then existing equities and rights of third parties therein, all assets held by said Section 77B Trustee for the account of others; and why such other, further and different relief should not be granted in the premises as may be just and proper; and

A hearing on said petition and order to show cause dated May 5, 1939, having been had on May 19, 1939, and an adjourned session of such hearing having been had on May 26, 1939, and the RFC at such hearing and adjourned session having proposed certain further amendments to the amended Plan under date of May 19, 1939, and May 26, 1939, respectively; and

The Section 77B Trustee herein having submitted and filed in this proceeding his own affidavit and the affidavit of Ira K. Balsam, both dated May 19, 1939, and the supplemental affidavit of Ira K. Balsam, dated May 26, 1939, respecting claims allowed herein, and the requisite acceptance in writing of the amended Plan having been so filed, and due proof having been submitted as to the performance of all other conditions precedent to confirmation of the amended Plan;

Now, upon said order of August 16, 1935, and upon said petitions and orders to show cause, together with proof of the publication, service and mailing of notice thereof as therein provided, and upon the Plan, the aforesaid acceptance thereof, and all proceedings heretofore had herein, it is

ORDERED, ADJUDGED AND DECREED, and this Court does FIND, as follows:

1. By an order entered herein, dated April 22, 1938, this Court adjudged the Plan duly proposed.

2. By an order entered herein, dated April 25, 1938, this Court adjudged the Debtor to be insolvent. No class of stockholders of the Debtor is affected by the Plan and the Plan properly makes no provision for any such stockholders.

3. By an order entered herein, dated May 3, 1938, this Court directed (a) that any party in interest desiring to make objections to, or propose changes in or modifications of, the Plan, might file such objections or such proposed

changes or modifications in writing on or before May 27, 1938 (which time was thereafter extended); (b) that the hearing on the Plan be adjourned until June 10, 1938, at which time such objections or proposed changes or modifications should be considered; (c) that the Section 77B Trustees of the Debtor publish notice of the hearing of June 10, 1938, and of the opportunity to file such objections and proposals; and (d) that a copy of the Plan and an appropriate form of acceptance, together with a copy of such published notice, be mailed to creditors not later than May 13, 1938. Notice was published as directed, and copies of the Plan and of the published notice, and a form of acceptance, were duly mailed to creditors on or before May 13, 1938.

4. Objections to and proposed changes in and modifications of the Plan were filed herein, and were considered on June 10, 1938, and at adjourned sessions of the hearing on the Plan. Amendments to the Plan were offered by the RFC in proposals dated June 17, 1938, and July 22, 1938, respectively, and such proposals were considered at adjourned sessions of the hearing on the Plan. Copies of the RFC's proposed amendments were served on the parties and interveners herein prior to such adjourned sessions, and arguments of counsel thereon were heard. None of the RFC's amendments was or is materially adverse to the interest of any creditor other than the RFC.

5. By order of this Court dated August 3, 1938, it was adjudged (a) that the Plan, amended as proposed by the RFC as aforesaid, was fair and equitable and that it did not discriminate unfairly in favor of any class of creditors or stockholders and that it was feasible; (b) that the amended Plan complied with the provisions of subdivision (b) of Section 77B of the Bankruptcy Act; (c) that the Debtor was not a utility, and it was therefore unnecessary to comply with the provisions of subdivision (e), clause (2), of Section 77B; and (d) that for the purposes of the

amended Plan and its acceptance, creditors of the Debtor whose claims would be affected thereby should be classified as follows: (1) the United States of America; (2) creditors who came within the definition of Secured Participants as set out in Article I of the amended Plan; and (3) all other creditors whose claims would be affected by the amended Plan. The RFC is an Unsecured Participant as defined in the amended Plan.

6. In its Petition for Confirmation and at the hearing thereon held May 19, 1939, and at the adjourned session thereof held May 26, 1939, the RFC proposed further amendments to the amended Plan. None of such amendments is materially adverse to the interest of any creditor. Copies of this Court's order to show cause, dated May 5, 1939, issued in respect of such Petition, together with copies of all papers thereto annexed, were duly served, and notices in the form therein set forth were duly published and mailed, all as in said order provided.

7. All provisions of such proposed further amendments with respect to distributions under the amended Plan (including, but without limitation, the proposed further amendments of paragraphs 2 and 3 of Article IV) are hereby adopted by this Court with the same force and effect as though set forth in detail in this order; and all provisions (including, but without limitation, all provisions as to how claims and interests should be evidenced for the purpose of participating in any plan of reorganization in this proceeding) contained in the order of this Court dated August 16, 1935, or in any other order heretofore entered in this proceeding, are hereby amended to the extent required to give effect to the foregoing. The assignment, on or after February 1, 1935 and prior to the Effective Date of the amended Plan, of a bond or of a mortgage participation certificate issued by Prudence-Bonds Corporation and guaranteed by the Debtor (or of an instrument representing a beneficial interest therein, such as,

but not necessarily limited to, a Trustee's certificate) shall be deemed, for all purposes of any plan of reorganization herein, to have effected an assignment of the assignor's guarantee claim against the Debtor (whether or not an instrument evidencing the assignment of such claim has been filed with the Section 77B Trustee) unless the assignor reserved to himself the rights against the Debtor based upon the Debtor's guarantee of such bond or certificate; provided, however, that unless such assignor, by proof filed with the Clerk of this Court on or before July 15, 1939, establishes to the satisfaction of this Court as evidenced by an adjudication, upon a hearing after such notice to the current holder of such bond or certificate and to the custodian of the register of the particular issue or series as this Court may direct, that such a reservation was made, it shall be conclusively presumed that no such reservation was made.

8. By its aforesaid order dated August 16, 1935, this Court decreed that for the purpose of accepting or consenting to any plan of reorganization, claims and interests should be evidenced by the filing and allowance thereof in the manner therein set forth. Paragraph 9 of said order provided among other things that duly filed claims should be deemed finally allowed unless objections were interposed prior to December 1, 1935. The time permitted for interposing such objections was thereafter variously extended, but it has now expired.

9. The aggregate amount of claims which have been allowed herein and remain unpaid is $133,723,298.95, consisting of the following, as more particularly set forth in the affidavits of Ira K. Balsam dated May 19, 1939, and May 26, 1939, respectively, hereinabove referred to:

(a) Claims in respect of the guarantee by the Debtor of bonds issued by Prudence-Bonds Corporation, in the principal amount of such bonds outstand-

ing as of February 1, 1935 (except such bonds as were owned by the Debtor at any time on or after February 1, 1935 and prior to said Effective Date), together with interest thereon due and unpaid as of February 1, 1935. The aggregate amount of such allowed claims is $58,833,179.79, consisting of $54,072,645.00 in respect of principal and $4,760,534.79 in respect of interest.

(b) Claims in respect of the guarantee by the Debtor of certificates issued by Prudence-Bonds Corporation, in the principal amount of such certificates outstanding as of February 1, 1935 (except such certificates as were owned by the Debtor at any time on or after February 1, 1935 and prior to said Effective Date) together with interest thereon due and unpaid as of February 1, 1935; provided, however, that all claims in respect of certificates of the so-called 1111 Park Avenue, Park Place Dodge, 100 West 55th Street, Blind Brook, Worthco and Dryden issues have been discharged by the payment thereof or by releases contained in the respective plans of reorganization of such certificate issues. The aggregate amount of such allowed claims is $50,857,852.86, consisting of $47,690,401.13 in respect of principal and $3,167,451.73 in respect of interest;

(c) Claims in respect of the guarantee by the Debtor of single mortgages (other than mortgages securing bonds or certificates issued by Prudence-Bonds Corporation) in the aggregate amount of $12,523,461.00;

(d) The RFC's claim, allowed for voting purposes in the aggregate amount of $11,357,577.45;

(e) Other claims in the aggregate amount of $151,227.85.

All claims and interests founded upon bonds or mortgage participation certificates issued by the Debtor have been

discharged by reason of separate reorganizations thereof consummated in this proceeding.

10. The provisions of Sections 198, 224 and 267 of Chapter X of the Bankruptcy Act, as amended by the Act of Congress of June 22, 1938, are deemed applicable to this proceeding.

11. All amendments proposed by the RFC as aforesaid are hereby approved and declared effective by this Court, and Exhibit A hereto attached constitutes the amended Plan.

12. The amended Plan has been accepted in writing, and such acceptance has been filed in this proceeding by or on behalf of creditors of the Debtor holding at least two-thirds in amount of the claims of each class of creditors whose claims have been allowed and would be affected by the Plan. Creditors of the Debtor as classified by the order of this Court, dated August 3, 1938, for the purposes of the amended Plan and its acceptance, and acceptances of the amended Plan by such creditors, are as follows:

	Allowed Claims	*Acceptances*	*%*
1. United States of America	$ 400,000.00	$ 400,000.00	100
2. Secured Participants.......	$122,214,493.65	$85,352,494.45	69.8
3. Other.........	$ 11,508,805.30	$11,359,187.24	98.7

No acceptance of the amended Plan by or on behalf of stockholders of the Debtor of any class is requisite.

13. There has been filed in these proceedings a statement, verified in a manner hereby approved, showing what contracts of the Debtor are executory in whole or in part and what unexpired leases have been rejected and surrendered.

14. By reason of the number of outstanding securities of the Debtor, or guaranteed by the Debtor, and the extent of the public dealing therein, it would be impractical to prepare a statement showing what, if any, claims and shares of stock have been purchased or transferred by those accepting the amended Plan after the commencement or in contemplation of this proceeding, and the circumstances of such purchase or transfer, and accordingly it is hereby directed that such a statement be not filed.

15. By an order dated April 21, 1939, this Court, among other things, approved a proposed certificate of incorporation of and by-laws for Prudence Realization Corporation, the New Company contemplated by the amended Plan. Pursuant to said order, the New Company was thereupon duly organized under the Stock Corporation Law of the State of New York, with a certificate of incorporation and by-laws in the form approved as aforesaid. By said order this Court found that the persons named as directors in such certificate of incorporation had been duly designated as such, pursuant to the applicable provisions of the amended Plan, that the identity, qualifications and affiliations of such persons had been fully disclosed, and that the appointment of such persons as such directors was equitable, compatible with the interests of the creditors and stockholders and consistent with public policy. At the instance of the directors, the identity, qualifications and affiliations of the persons who are to be officers of the New Company, upon consummation of the amended Plan, together with the aggregate compensation to be paid to the principal officers of the New Company during the first year following the Effective Date of the amended Plan, have been fully disclosed by an affidavit of the Section 77B Trustee dated May 25, 1939. The appointment of such persons to such offices is equitable, compatible with the interests of the creditors and stockholders and consistent with public policy, and such aggregate compensation is approved as fair and reasonable.

16. After hearing all objections which have been made to the amended Plan and its confirmation, this Court is satisfied that:

(a) the Plan and all amendments thereto approved by this Court have been duly proposed and considered at a hearing or hearings duly noticed for their consideration, all in conformity with subdivision (d) of Section 77B;

(b) all creditors and stockholders of the Debtor and all other interested persons have had a fair opportunity to make objections to the amended Plan and its confirmation and to be heard thereon;

(c) the amended Plan is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible;

(d) the amended Plan complies with, and has been accepted as required by, all applicable provisions of law;

(e) the provisions of subdivision (e), clause (2), of Section 77B are not applicable;

(f) all amounts to be paid by the Debtor or by any corporation or corporations acquiring the Debtor's assets, and all amounts to be paid to committees or reorganization managers, whether or not by the Debtor or any such corporation, for services or expenses incident to the reorganization, have been fully disclosed and are reasonable, or are to be subject to the approval of the judge in charge of the proceeding;

(g) the offer of the Plan and all amendments thereto approved by this Court, and the acceptance thereof, have been made in good faith and have not been made or procured by any means or promises forbidden by the Bankruptcy Act;

(h) the Debtor, and every other corporation issuing securities or acquiring property under the amended Plan, are authorized by their respective charters or by applicable State or Federal laws, upon confirmation of the amended Plan, to take all action necessary to carry out the amended Plan;

(i) the identity, qualifications and affiliations of the persons who are to be directors or officers of the New Company, upon consummation of the amended Plan, have been fully disclosed, and the appointment of such persons to such offices is equitable, compatible with the interests of the creditors and stockholders and consistent with public policy; and

(j) all other conditions precedent, if any, to the confirmation of the amended Plan under any applicable provision of law, have been complied with.

17. The amended Plan is hereby in all respects approved and finally confirmed.

18. The Section 77B Trustee of the Debtor is hereby directed, solely in consideration for the issuance to such Trustee acting on behalf of the Debtor of all the authorized capital stock of the New Company, forthwith (a) to execute and deliver to the New Company an assignment substantially in the form annexed as Exhibit C to the Petition for Confirmation, and (b) to deliver and surrender to the New Company possession of and control over the assets and business to which such assignment relates. The date of the execution by such Trustee of such assignment shall be the Effective Date of the amended Plan. The Debtor is hereby ordered to join in the execution of such assignment, and the New Company is hereby ordered to execute the acceptance and undertaking set forth at the foot thereof. All depositaries having funds on deposit credited to the Debtor's estate are hereby directed to trans-

fer such accounts to the New Company upon the written request of the Section 77B Trustee; the signature of the Clerk of this Court shall not be required to effect the transfer of such accounts.

As soon as practicable, the Section 77B Trustee shall execute and deliver to the New Company such further instruments of assignment, transfer, grant and conveyance (including, without limitation, deeds of real estate, assignments of mortgages, endorsements and powers of attorney) and shall effect such manual deliveries to the New Company, as the New Company reasonably may require to further assure the vesting in the New Company, as provided in Article III of the amended Plan, of the assets and business thereby required to be so vested; and the Debtor is hereby ordered to join in the execution of such instruments upon the request of the New Company.

Each bond and certificate issued by Prudence-Bonds Corporation and any other instrument included among such assets which was guaranteed by the Debtor shall be stamped, prior to delivery to the New Company, with a legend to the effect that such guarantee has been cancelled.

Forthwith upon the issuance by the New Company of its stock as hereinabove provided, the Section 77B Trustee shall assign and transfer one share of Class A stock to each of the five Class A directors and one share of Class B stock to each of the two Class B directors of the New Company, whereupon, as provided in Article III of the amended Plan, each such director shall enter into a written agreement substantially in the form approved by the aforesaid order of this Court dated April 21, 1939. The Debtor is hereby ordered to join in the execution of each such assignment and transfer.

19. The assets and business to be vested in the New Company shall be free and clear of all claims and interests of the Debtor, its stockholders and creditors, and

others, except the following which shall remain outstanding:

(a) claims for amounts due as taxes to the United States of America and the State of New York, and the items provided for in Article VIII of the amended Plan,

(b) finally allowed claims against the property of the Debtor in respect of which the Debtor is not personally liable, and

(c) finally allowed claims of the character which shall entitle the holders thereof to be deemed Participants as defined in Article I of the amended Plan.

There are no claims or interests having priority except the claims and items referred to in the foregoing subdivision (a).

The claims referred to in the foregoing subdivision (b) shall be payable only out of the property against which they are claims.

The claims and items referred to in the foregoing subdivisions (a) and (c) shall be paid by the New Company, but only as follows:

The claims and the items referred to in the foregoing subdivision (a) shall be paid in full in due course out of the New Company's assets. Such claims and items shall not constitute liens upon such assets, but shall have priority over all distributions to Participants under the amended Plan and over all liabilities incurred by the New Company; and the New Company shall be entitled to sell all or any part of such assets free and clear of any charge in respect of such claims and items.

The claims referred to in the foregoing subdivision (c) shall not constitute liens upon the New Company's assets, and the New Company shall be entitled to sell all or any part of such assets free and clear of any charge in respect of such claims; provided, however, that nothing herein con-

tained shall be deemed to affect the lien, if any, to which any part of such assets was subject, immediately prior to the vesting thereof in the New Company, in respect of any such claim. The claims referred to in such subdivision (c) shall be payable, without interest, only as provided in Article IV of the amended Plan and only to the extent that the New Company's assets shall be sufficient to pay them, after reserving from such assets $70 for the New Company's capital and $70 for its surplus, and after payment of or provision for (i) the amounts and items referred to in the foregoing subdivision (a), and (ii) such liabilities as may be incurred by the New Company. Such surplus shall be available to pay for stock which may be purchased by the New Company under the options provided for in Article III of the amended Plan.

20. The Section 77B Trustee of the Debtor is hereby further directed to transfer to the New Company forthwith, subject to all then existing equities and rights of third parties therein, all assets held by said Section 77B Trustee for the account of others, or held by said Section 77B Trustee in any agency or other segregated account pending settlement or determination of equities or rights asserted by others. The moneys in the bank accounts denominated "The Estate of The Prudence Company, Inc., Debtor, Nos. 27496 & 27028, Servicing Fees Reserve Account", in Brooklyn Trust Company, 177 Montague Street, Brooklyn, N. Y., Kings County Trust Company, 372 Fulton Street, Brooklyn, N. Y., Lawyers Trust Company, 185 Montague Street, Brooklyn, N. Y. and The National City Bank of New York, Court Street at Montague Street, Brooklyn, N. Y., may be dealt with by the New Company, without further order of this Court, upon due settlement or determination of the New Company's interest therein, provided, however, that, pending such settlement or determination, the moneys in such accounts shall be retained in a segregated agency account or accounts; and the order

of this Court dated August 16, 1935, under which such moneys have heretofore been held by the Section 77B Trustee, and the order of this Court dated February 1, 1935, as amended by said order of August 16, 1935, are hereby amended to the extent required to give effect to the foregoing. Upon receipt of a certified copy of this order, the banks named herein shall take such steps as may be necessary or appropriate to effectuate the transfer of such accounts to the New Company.

21. The New Company is hereby directed to pay in full in due course all Federal taxes, if any, due from the Section 77B Trustee, in respect of the period between December 31, 1937 and the Effective Date of the amended Plan, whether or not a claim for such taxes shall have been filed or allowed by this Court.

22. On and after the Effective Date, the RFC's claim shall stand allowed in the amount of $11,347,775.50, without prejudice to such right as the RFC may have, under the provisions of Section 77B(c)(9), or other applicable provisions of law, to be compensated for services rendered and to be reimbursed for expenses incurred in connection with the proceedings and the amended Plan.

23. All causes of action or rights against present or former officers or directors of the Debtor, and against other parties arising out of or relating to the transactions giving rise to such causes of action or rights, including those asserted in the suits instituted in the Supreme Court of the State of New York, County of New York, by the Section 77B Trustees, captioned Stephen Callaghan, et al., Plaintiffs v. Frank Bailey, et al., Defendants, and by Julia Regan, et al., captioned Julia Regan, et al., Plaintiffs v. The Prudence Company, Inc., et al., Defendants, shall survive the confirmation and consummation of the amended Plan and shall not be deemed to have been abandoned.

24. The provisions of the amended Plan and of this order shall be binding upon (a) the Debtor, (b) all stockholders of the Debtor, (c) all creditors of the Debtor, secured or unsecured, whether or not affected by the amended Plan, and whether or not their claims or interests shall have been filed and, if filed, whether or not scheduled, allowed or allowable, including creditors who have not, as well as those who have, accepted the amended Plan, and (d) the New Company.

25. THIS COURT RESERVES JURISDICTION:

(a) to take all such further action as may be required in aid of the consummation of the amended Plan, including, but not limited to, the giving of such directions, authorizations or approvals as this Court may determine in regard to instruments of transfer and conveyance of the property dealt with by the amended Plan; and to take all action contemplated by the provisions of Article V of the amended Plan to be taken by this Court with respect to the valuations therein provided for;

(b) To approve duly proposed changes in and modifications of the amended Plan, after hearing duly noticed, subject to the right of any creditor who shall previously have accepted the amended Plan to withdraw his acceptance, within a period to be fixed by the judge in charge of the proceeding and after such notice as such judge may direct, if, in the opinion of such judge, the change or modification will be materially adverse to the interest of such creditor; provided, however, that the amended Plan as changed or modified shall comply with all applicable provisions of law and shall have been or shall thereafter be duly accepted;

(c) from time to time to make such orders, adjudications and decrees respecting claims or the assignment or registration thereof or distributions thereon.

including, without limitation, adjudications of the character contemplated by paragraph 7 hereof, and respecting the assets, equities and rights referred to in paragraph 20 hereof, all as justice may require;

(d) to allow and direct the payment of all expenses, costs and allowances provided for in Article VIII of the amended Plan;

(e) upon the termination of the proceeding, to enter a final decree discharging Stephen Callaghan, John M. McGrath and William T. Cowin as Trustees of the Debtor's estate (the first two named having heretofore resigned), making such provisions as may be equitable, by way of injunction or otherwise, and closing the case; to discharge the Debtor from its debts and liabilities, and to terminate and end all rights and interests of its stockholders, except as provided in the amended Plan; and

(f) generally to determine any and all matters pertaining to this proceeding or to the amended Plan and not determined heretofore or by this order.

26. The Section 77B Trustee is directed to publish, on or before June 3, 1939, in the New York Times and Brooklyn Daily Eagle, newspapers of general circulation in the City of New York, a notice of the entry of this order in substantially the following form:

In the United States District Court, for the Eastern District of New York; In the Matter of The Prudence Company, Inc., Debtor; consolidated proceedings for the reorganization of a corporation under Section 77B of the National Bankruptcy Act, Index Nos. 27496 and 27028;

To all creditors and stockholders of The Prudence Company, Inc., and all other persons in any wise interested in the above entitled proceeding;

Take notice that an order dated May 26, 1939, has been entered herein which, among other things, (a) provides how and to whom distributions shall be made under the general Plan of Reorganization of the said Debtor, dated April 12,

1938, proposed by Reconstruction Finance Corporation, including a provision (more fully set forth in the amended Plan) to the effect, in the case of each claim founded on the Debtor's guarantee of a bond or certificate, that such distributions shall be made to the holder of such bond or certificate unless a person who disposed of such bond or certificate between February 1, 1935 and the Effective Date of the amended Plan, by proof filed with the Clerk of this Court on or before July 15, 1939, establishes to the satisfaction of the Court that he reserved to himself the rights against the Debtor based on the Debtor's guarantee thereof, in which case such distributions shall be made to such person; (b) amends, to the extent required to give effect to such provisions, the previous orders of the Court herein, including the order dated August 16, 1935, relative, among other things, to the manner in which claims and interests of creditors in this proceeding should be filed or evidenced for the purposes therein set forth; (c) approves all amendments proposed by Reconstruction Finance Corporation to said Plan, including those proposed by it in its petition dated May 5, 1939, and at the hearing thereon and the adjourned session thereof; (d) confirms the Plan as amended; and (e) directs the Section 77B Trustee of the Debtor to vest forthwith in the New Company provided for in the amended Plan the assets and business thereby required to be so vested, free and clear, except as provided in the amended Plan, of all claims and interests of the Debtor, its stockholders and creditors, and others, and further, to transfer to such New Company, subject to all then existing equities and rights of third parties therein, all assets held by said Section 77B Trustee for the account of others, or held by said Section 77B Trustee in any agency or other segregated account pending settlement or determination of equities or rights asserted by others.

Copies of said order and copies of the amended Plan as confirmed by the Court may be obtained upon request at the office of the Section 77B Trustee of the Debtor, 331 Madison Avenue, New York, N. Y., or at the office of the solicitors for Reconstruction Finance Corporation, Messrs. Root, Clark, Buckner & Ballantine, 31 Nassau Street, New York, N. Y.

William T. Cowin,
Section 77B Trustee of The Prudence Company, Inc.

and the Section 77B Trustee is further directed to mail, on or before June 3, 1939, a copy of said notice to all persons who have duly filed proofs of claim herein (or their

assignees on the records of such Trustee) unless such claims have been heretofore discharged or disposed of otherwise than by their allowance. The cost of such publication and mailing shall be paid out of the funds in the Debtor's estate, and promptly upon completion thereof due proof of such publication and mailing shall be filed with the Clerk of this Court by the Section 77B Trustee. No failure to comply with the provisions of this paragraph 26 shall in any wise affect the effectiveness of the other provisions of this order or of the amended Plan.

27. The hearing on the above mentioned petition of April 12, 1938, the order to show cause dated April 13, 1938, the amended Plan, the Petition for Confirmation, and the order to show cause dated May 5, 1939, is hereby adjourned to June 23, 1939.

Dated, May 26, 1939.

GROVER M. MOSCOWITZ,
U. S. D. J.

[fol. 36] IN UNITED STATES DISTRICT COURT, EASTERN DISTRICT OF NEW YORK

[Same title]

REPLYING AFFIDAVIT OF A. JOSEPH GEIST, READ IN SUPPORT OF MOTION

STATE & CITY OF NEW YORK,
County of New York, ss:

A. Joseph Geist, being duly sworn, deposes and says: That he is the Trustee of Zo-Gale First Mortgage Participation Certificate Issue, and submits this affidavit in reply to the answering affidavit interposed by William T. Cowin in opposition to the application made by your deponent for an order determining that the interests of the Prudence Realization Corporation in the Zo-Gale Issue are subordinate to the certificates held by the general public.

Your deponent respectfully calls the attention of this Court to certain pertinent facts and data which, in your deponent's opinion, constitute the basis for the determination of the question involved in this proceeding. Your deponent has annexed to the petition in support of the order sought herein a copy of the certificates issued in the Zo-Gale Issue by Prudence-Bonds Corporation and which were sold and guaranteed by The Prudence Company, Inc. to the general public. The certificate provides in part thereof as follows:

"Prudence-Bonds Corporation, hereinafter called 'The Corporation', has received from —— for the purchase of, and hereby assigns to the purchaser, an undivided share equal to that amount, with interest thereon at the rate of —%, —— for $—— dated —— —, 19—, due —— —, 19—, and in the first mortgage securing the same, covering ——."

[fol. 37] The certificate, which was issued by Prudence-Bonds Corporation and guaranteed and sold by The Prudence Company, Inc., which is therein referred to as the "Guarantor", provides in part thereof as follows:

"2. The Corporation upon the receipt of the interest and principal of said bond and mortgage shall distribute the same pro rata among the parties entitled thereto.

3. The Corporation and/or the Guarantor shall have full power to take any action it may deem necessary or desirable in order to enforce any of the provisions of said bond and mortgage and to protect the mortgage security.

4. The Corporation may for its own corporate account, be the holder or pledgee of similar shares in said bond and mortgage."

These extracts from the certificate issued by Prudence-Bonds Corporation brings sharply to light the position of The Prudence Company, Inc., the guarantor and seller of the certificates. It discloses that The Prudence Company, Inc. recognized that as a guarantor, debtor, it could not be the holder or pledgee of certificates issued in the series on a parity with those issued to the general public. It failed to reserve to itself the right to hold shares or retain shares for its own account.

The Prudence Realization Corporation, the successor in interest of The Prudence Company, Inc., cannot now seek to acquire greater rights than The Prudence Company, Inc. had, and cannot seek to establish that any interest retained by The Prudence Company, Inc., in the uncertificated issues is on a parity with the certificates held by the general public. The guarantee executed by The Prudence Company, Inc. places it squarely in the position of a debtor as to each person who holds a mortgage participation cer- [fol. 38] tificate and the equitable rule existing between debtors and creditors must be recognized and applied; to attempt to place the re-purchased and uncertificated portions of this mortgage held by The Prudence Company, Inc., the guarantor, on a parity with those sold and delivered to the certificate holders, would utterly and completely destroy this well-established and long existing rule of law.

No creditor without cause may be compelled to release a part or portion of the security to which he may look to satisfy the obligation due him, nor may the debtor while insolvent and unable to meet its obligation divert the security which was made expressly responsible for the payment of this existing obligation. Surely this principle is not subject to question. We must merely ascertain the facts, the origin and history of the certificates in question, the ownership of the certificates and from whom present holders acquired title, and apply the rules of law applicable to the facts found.

General History of Certificates Held by The Prudence Company, Inc. and of the Certificates Sold by it to the General Public

The Trustees of The Prudence Company, Inc., upon their appointment and qualification following the filing and approval of the plan of reorganization of The Prudence Company, Inc., debtor, came into the possession of certain assets including the unissued certificates and the re-purchased certificates involved herein.

The Prudence Company, Inc., a banking corporation, was engaged in the sale of guaranteed mortgage certificates to the general public. Its practice generally was to lend its money to owners of real estate on improved property, who would execute and deliver a bond and mortgage as security therefor. The Prudence Company, Inc. would then assign this bond and mortgage to Prudence-Bonds Corporation, and Prudence-Bonds Corporation would issue [fol. 39] undivided shares to The Prudence Company, Inc. These shares or certificates were thereupon guaranteed by The Prudence Company, Inc. and sold by The Prudence Company, Inc. to the general public.

The assignment of the bond and mortgage to Prudence-Bonds Corporation was in form absolute. However, your deponent has been informed and verily believes that Prudence-Bonds Corporation, the alter-ego of The Prudence Company, Inc., did not part with any consideration upon the assignment to it of the Zo-Gale bond and mortgage. Prudence-Bonds Corporation was a mere conduit used by The Prudence Company, Inc. for the issuance of the securities which were guaranteed and sold by The Prudence Company, Inc. to the general public.

Prudence-Bonds Corporation did not have the capital or financial resources to enable it to purchase the bond and mortgage assigned to it. The real purpose of the assignment of the bond and mortgage to Prudence-Bonds Corporation was fully carried out when Prudence-Bonds Corporation certified and delivered the certificates or shares in such bond and mortgage to The Prudence Company, Inc., so that the sale thereof by The Prudence Company, Inc. to the general public could be facilitated. That is the only way in which the Prudence-Bonds Corporation became involved in the transaction. In fact, the common stock of The Prudence Company, Inc. and the common

stock of Prudence-Bonds Corporation were both wholly owned and held by a common parent company, New York Investors Inc.

In the normal course of events, Prudence Company, Inc. sold to the general public certificates or undivided shares of the Zo-Gale issue, herein described, aggregating $382,800., leaving $7,200. worth of certificates unissued and in the portfolio of The Prudence Company, Inc. The proceeds that were received upon the sale of these certificates constituted the absolute property of The Prudence Company, [fol. 40] Inc. and at no time were considered or treated as the property of Prudence-Bonds Corporation.

In 1932, the Prudence Company, Inc. re-purchased two certificates, one in the sum of $500., and one in the sum of $300., which had theretofore been sold to the public, and had the c ificates issued in its own name. As a result of various cancellations, The Prudence Company, Inc. also became entitled to a certificate for $16.67. The Prudence Company, Inc. in this manner re-acquired certificates totalling $816.67 additional.

William T. Cowin, president of Prudence Realization Corporation, the respondent herein, formerly a trustee of the debtor, states in his affidavit that in many instances The Prudence Company, Inc. re-acquired certificates theretofore sold to and held by the public, and that it was the intention of The Prudence Company, Inc. to hold such certificates in its own investment portfolio as an investment.

Your deponent does not take any exception to such statement, but respectfully submits that this presents an incomplete picture. The mortgagor, Zo-Gale Realty Co., Inc., undoubtedly paid interest on the whole mortgage. Who received the balance above that required to be paid to the certificate holders? Who received the interest on the unissued certificates of $7,200.?

Your deponent has been informed and verily believes that these interest payments were retained by The Prudence Company, Inc., who as the owner thereof, was entitled to receive such interest. The arrangement that existed was one of convenience only between The Prudence Company, and Prudence-Bonds Corporation, and it was acknowledged that The Prudence Company, Inc. at all times was the owner of the uncertificated portion of the mortgage.

The records show that The Prudence Company, Inc. at all times claimed ownership of the unissued portion of the Zo-Gale mortgage of $7,200 and this claim was recognized by the court. In the proceeding for the reorganization of [fol. 41] The Prudence Company, Inc., the Trustees on December 15th, 1937, procured an order to show cause why a certain proposed compromise of the claims asserted on behalf of The Prudence Company, Inc. in the reorganization of the Prudence-Bonds Corporation should not be accepted. The petition submitted in support of the compromise alleged certain claims arising out of eighteen series of bonds, and in addition asserted ownership of, "unissued certificates", that is, the difference between the face amount of the mortgage and the amount of certificates actually issued and sold to the public.

Annexed to that petition is a statement which sets forth the various proofs of claim filed in that reorganization proceeding on behalf of The Prudence Company, Inc. and the proposed compromise. The following is an extract in part:

"(1) We will accept subordination of the Prudence-Bonds of the eighteen series owned and held by us as Trustees of The Prudence Company, Inc. * * * as subordination is defined in paragraph 11 of the several plans of reorganization for the eighteen series of bond issues and also as provided for and defined in the order of Hon. Robert A. Inch made on July 21, 1937. We will submit our bonds for stamping with an appropriate legend indicating such subordination.

* * * * * * *

(3) We will withdraw and consent to the expunging of all the following proofs of claim heretofore filed by or on behalf of The Prudence Company, Inc. in the proceedings for the reorganization of Prudence-Bonds Corporation * * *"

These specific proofs of claim are then listed and the proposal continues:

"except in so far as any of the foregoing proofs of claim may constitute a claim in and to the uncertificated portions of certain certificated mortgages more fully described hereafter. * * *"

[fol. 42] The compromise was approved by this Court and the Trustees of The Prudence Company, Inc. received the uncertificated portion of the Zo-Gale certificate issue of $7,200. The approval by the Court of the proposal was an affirmation of the recognized existing fact that The Prudence Company, Inc. was at all times the true and equitable owner of the unissued portion of this mortgage, title to which was at all times claimed and asserted by The Prudence Company, Inc.

In point of fact, the affidavit submitted in opposition to the instant application seeks to capitalize that which it chooses to classify as the election of certificate holders, by virtue of the proofs of claim filed in the reorganization of The Prudence Company, Inc., to come in as unsecured creditors rather than as secured creditors, and by virtue of such election the unissued portion of this mortgage acquired a sanctimonious halo, and should now be declared to be on a parity with the certificates held by the public.

Your deponent has been informed and verily believes that in the proceeding for the reorganization of The Prudence Company, Inc. forms for filing proofs of claim were prepared and sent to all certificate holders by the Prudence Company, Inc. or the Trustees of The Prudence Company, Inc. A copy of the form of proof of claim which the certificate holder was requested to complete is annexed to the answering affidavit. The certificate holder, among other questions, was asked to list the security; that is, the certificates held by him in each issue and each certificate holder set forth the certificates held by him. The certificate holders thus filed proofs of claim as secured creditors.

The certificate holders are now sought to be charged with negligence in not having filed a proof of claim against the unissued certificates owned by The Prudence Company, Inc., and that they thereby released their right to assert a claim against these specific holdings of The Prudence Company, Inc. The proof of claim required the certificate [fol. 43] holders to state on such proof of claim those certificates which the certificate holder, "was on * * * February 1st 1935, * * * and still is, the lawful owner and holder of * * * participation certificate(s)".

We quote from paragraph 3 of the form of proof of claim:

"3. That the claimant was on February 1, 1935, the date of the approval of the petitions for the reorganization of

the Debtor herein, and still is, the lawful owner and holder of Prudence-Bonds Corporation mortgage participation certificate(s), and, if the same be not registered, of the coupons appurtenant thereto, which mortgage participation certificate(s) are described as follows:

Serial Number	Interest Rate	Principal Amount	Name of Issue

* * * * * * *

that the foregoing constitutes a statement of claimant's claim herein * * *."

The language employed was that of the debtor which prepared the proof of claim and not that of the certificate holder and, of course, must be construed strictly in favor of the certificate holders and against the debtor, The Prudence Company, Inc., which prepared the same.

This statement is not intended to be a concession that by filing such proof of claim the certificate holders waived their rights with respect to that portion of the certificates held by The Prudence Company, Inc., and did not constitute a release. In fact, we contend that the certificate holders' claims were originally filed as secured claims. The order of this court entered on February 19th, 1938, set forth in paragraph "12th" of the petition dated May 7th, 1940, recognizes the fact that a dispute existed as to said certificates held by The Prudence Company, Inc., or [fol. 44] the Trustees of The Prudence Company, Inc., and reserved for future determination the claim of The Prudence Company, Inc., that such certificates were in fact on a parity. The reservation of this question precludes the Prudence Realization Corporation, the successor of The Prudence Company, Inc., debtor, from making any greater claim than the Trustees of The Prudence Company, Inc., had to such uncertificated portion of such mortgage.

The reorganization of the Zo-Gale Issue expressly reserved to the certificate holders all their rights against The Prudence Company, Inc. (see paragraph #13 of the petition dated May 7th, 1940), which sets forth an excerpt from the original plan of reorganization, as amended by the order dated December 10th, 1937.

Your deponent disputes the contention urged by the respondent that if the certificates were held by the Prudence-Bonds Corporation, that they would be entitled to be placed on a parity with those held by the general public. This contention assumes a state of facts, which never existed, and could not possibly exist since Prudence-Bonds Corporation at no time paid any consideration for the bond and mortgage assigned to it and it was obligated under its understanding to issue Prudence Bonds in exchange therefor of the face amount of the mortgage assigned to it.

If Prudence-Bonds Corporation had purchased the certificates, then since no relationship of debtor and creditor existed or could exist between Prudence-Bonds Corporation and the general public, and since the certificates issued to the general public contained the express proviso that "The Corporation", Prudence-Bonds Corporation, might be the holder or pledgee of similar certificates for its own account, Prudence-Bonds Corporation in such circumstances would be entitled to have those certificates held by it declared to be on a parity with those held by the general public. The facts herein, however, estop the respondent from urging the position it seeks to adopt.

[fol. 45] The Prudence Company, Inc., in the reorganization of the Prudence-Bonds Corporation, litigated the question as to the parity of the bonds held by it with those held by the general public, and as stated in the affidavit of William T. Cowin, both the Special Master to whom this question was referred and the District Court determined that question adversely to the Trustees of The Prudence Company, Inc. The decision of that court is stare decisis in this proceeding.

Wherefore, your deponent respectfully prays that an order be made and entered herein declaring that the certificates held by the Prudence Realization Corporation in the sum of $816.67 and the unissued principal amount of the mortgage in the sum of $7,200 not represented by outstanding certificates, are subordinate to the certificates guaranteed by The Prudence Company, Inc., held by the general public.

A. Joseph Geist.

(Sworn to October 23, 1940.)

[fol. 46] IN UNITED STATES DISTRICT COURT, EASTERN DISTRICT OF NEW YORK

[Same Title]

Geist & Neter, Attorneys for Trustee; Morris A. Marks, of Counsel.

Irving L. Schanzer, Attorney for Prudence Realization Corporation, Respondent.

OPINION OF MOSCOWITZ, D. J.

MOSCOWITZ, D. J.

This is a petition to declare certain interests of the Prudence Realization Corporation in a bond and mortgage of the Zo-Gale Realty Co., Inc., to be subordinate to the interests of third party certificate holders. The Prudence Company, Inc., hereinafter referred to as "Prudence", had loaned money to Zo-Gale Realty Co., Inc., and received therefor the latter's bond and mortgage. These in turn were assigned by Prudence to Prudence Bonds Corporation, hereinafter referred to as "Prudence Bonds", the only consideration being the issue by Prudence Bonds to Prudence of certificates of interest in the bond and mortgage thus assigned. Prudence then sold the certificates to the public accompanied by its guaranty. The practice followed in these issues by Prudence and Prudence Bonds, both of which were controlled by the same interests, is well described in In re The Westover, 82 F. (2d) 177 (C. C. A. 2d), In re Prudence Co., Inc., 89 F. (2d) 689 (C. C. A. 2d), and In re Prudence Co., Inc., 98 F. (2d) 559 (C. C. A. 2d). As pointed out in In re Prudence Bonds Corporation, 79 F. (2d) 212 (C. C. A. 2d), Prudence Bonds assumed no liability with respect to the certificates.

Some of the certificates sold by Prudence to the public were subsequently repurchased by it. In connection with [fol. 47] the reorganizations of Prudence and Prudence Bonds, the latter released to the former, as part of a compromise, all interest which it had in the uncertificated portion of the Zo-Gale mortgage. It is these two interests in the Zo-Gale mortgage, both now in the hands of Prudence Realization Corporation, as successor to the Trustees of

Prudence, which the present petition seeks to have subordinated to the certificates in the hands of the public.

So far as the uncertificated portion of the mortgage is concerned, the controlling authorities support the proposition that where a debtor who guarantees mortgage certificates, also holds an interest in the mortgage, it cannot share in the collateral until certificate holders are paid, unless there is clear reservation in the certificate of the right to share on a parity. Pink v. Thomas, 282 N. Y. 10; Matter of Title & Mortgage Guaranty Co., 275 N. Y. 347. The respondent does not dispute this proposition but contends that it is inapplicable by reason of the fact that the uncertificated interest was allegedly obtained in connection with reorganization proceedings, and that accordingly parity is to be granted. The respondent having thus assumed parity as a result of the reorganization transaction, concludes that the parity so assumed is binding in this proceeding. Cf. Stoll v. Gottlieb, 305 U. S. 165.

The difficulty with the respondent's analysis rests in the assumption that its uncertificated interest was derived from the reorganization compromise and that the compromise agreement implied parity. Actually, however, the uncertificated interest of the respondent was not wholly derived in that manner. It should be remembered that the assignment of mortgage from Prudence to Prudence Bonds was without consideration, and that therefore, to the extent that mortgage certificates were not delivered by Prudence Bonds to Prudence, the real ownership, as between the parties, remained in Prudence. When, therefore, in connection with [fol. 48] the reorganization compromise, Prudence Bonds released to Prudence any interest it might have in the uncertificated portion of the mortgage, that release did not effect the transfer to Prudence of any substantial interest that it did not already have as against Prudence Bonds. Accordingly, there is no basis for disregarding the rule set forth in Pink v. Thomas, supra.

The facts of Pink v. Thomas, supra, also concerned a certificated interest and as to this also the Court refused to allow parity. This Court sees no reason for departing from that rule. No claim of waiver can properly be asserted by the respondent since this question of parity has at all times been reserved.

No reservation of parity for the guarantor, Prudence, having been inserted in the mortgage certificates, both the

certificated and uncertificated interests of the respondent, Prudence Realization Corporation are subordinate to certificates in the hands of the public.

Settle order on notice.

Grover M. Moscowitz, U. S. D. J.

January 25, 1941.

[fol. 49] In United States District Court, Eastern District of New York

[Same title]

Order Appealed From

A. Joseph Geist, as trustee, having moved this Court by order to show cause dated the 13th day of May, 1940, why an order should not be made and entered declaring that the interest of the Prudence Realization Corporation in and to the outstanding certificates in the sum of $816.67 and in and to the unissued certificates in the principal amount of $7,200 of the Zo-Gale Realty Co. Issue is subject and subordinate to the certificates issued by Prudence Bonds Corporation, guaranteed by The Prudence Company, Inc., and held by the general public, and why payments of principal and interest on the certificates issued and unissued held by the Prudence Realization Corporation should not be deferred until the certificate holders have been paid in full the principal and interest guaranteed them under their certificates, and for such other and further relief as to the Court may seem just and proper in the premises, and the same having duly come on for hearing before the undersigned,

Now, upon reading and filing the order to show cause herein dated the 13th day of May, 1940, the affidavit of A. Joseph Geist, duly verified the 7th day of May, 1940, Exhibits 1 and 2 annexed thereto, the affidavit of William T. Cowin, duly sworn to the 26th day of September, 1940, Exhibits A, B, C and D annexed thereto, the reply affidavit of A. Joseph Geist, duly sworn to the 23rd day of October, 1940, and due deliberation having been had thereon, and after hearing Geist & Netter, by Morris A. Marks, Esq., attorneys for the trustee, in support of said motion, and [fol. 50] Irving L. Schanzer, Esq., attorney for the Prudence Realization Corporation, in opposition thereto, and upon

the opinion of this Court dated the 25th day of January, 1941, it is

Ordered, adjudged and decreed that the said motion be and the same is hereby in all respects granted; and it is further

Ordered, adjudged and decreed, that the interest of the Prudence Realization Corporation, successor in interest of The Prudence Company, Inc., in and to the certificates, issued and unissued, in the Zo-Gale Realty Co. Issue, be and the same is declared to be subordinate to the interest of third party certificate holders, and that the Prudence Realization Corporation, its successors and assigns, are not entitled to any distribution of interest or principal out of the trust estate on account of the certificates held by it until the third party certificate holders have been paid in full the principal and interest guaranteed under the certificates held by such third party certificate holder.

Dated, Brooklyn, New York, January 30th, 1941.

Grover M. Moscowitz, U. S. D. J.

[fol. 51] In United States District Court, Eastern District of New York

[Same title]

Notice of Appeal

Sirs:

Please take notice that Prudence Realization Corporation, the respondent herein, hereby appeals to the United States Circuit Court of Appeals for the Second Circuit, both on the law and the facts, from an order made and entered in the above entitled proceeding on the 30th day of January, 1941, by Hon. Grover M. Moscowitz, and that said Prudence Realization Corporation hereby appeals from each and every part of said order as well as from the whole thereof.

Dated: New York City, New York, February 13th 1941.

Irving L. Schanzer, Attorney for Prudence Realization Corporation.

To: The Honorable Clerk of the United States District Court for the Eastern District of New York. Geist & Netter, Esqs., Attorneys for A. Joseph Geist, Trustee.

[fol. 52] IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

[Title omitted]

STIPULATION DISPENSING WITH PRINTING OF PART OF RECORD

It is hereby stipulated and agreed by and between the attorneys for the respective parties to this appeal, that Prudence Realization Corporation, the appellant herein, may submit to the Court three copies of Exhibits "A", "B", "C", and "D" attached to the answering affidavit of William T. Cowin, dated September 26, 1940, in lieu of printing [fol. 53] each of said exhibits as part of the Record on this appeal from an order of Hon. Grover M. Moscowitz, United States District Judge, dated January 30, 1941.

Dated: New York, N. Y., February 11, 1941.

Irving L. Schanzer, Attorney for Prudence Realization Corporation. Geist & Netter, Attorneys for A. Joseph Geist, Trustee.

Feb. 18, 1941.

So ordered: August N. Hand, U. S. C. J.

[fol. 54] IN UNITED STATES DISTRICT COURT, EASTERN DISTRICT OF NEW YORK

[Title omitted]

STIPULATION AS TO RECORD

It is hereby stipulated and agreed that the foregoing is a true and correct transcript of the record of the said District Court in the above-entitled cause, as agreed on by the parties.

Dated, New York, March 11th, 1941.

Irving L. Schanzer, Attorney for Appellant. Geist & Netter, Attorneys for Appellee.

[fols. 55-56] Clerk's Certificate to foregoing transcript omitted in printing.

Opinion of Circuit Court of Appeals.

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 343—October Term, 1940.

(Argued June 9, 1941 Decided August 11, 1941.)

A. JOSEPH GEIST, Trustee,
Petitioner-Appellee,

— *v.* —

PRUDENCE REALIZATION CORPORATION,
Respondent-Appellant.

Appeal from the District Court of the United States for the Eastern District of New York.

In consolidated proceedings for the reorganization under Bankruptcy Act, §77B, of The Prudence Company, Inc., and Amalgamated Properties, Inc., A. Joseph Geist, trustee of real property of the latter company securing the payment of bond and mortgage participation certificates, petitions for an order subordinating the claims of Prudence Realization Corporation, successor of the former company, to those of other certificate holders. From an order granting the petition, respondent appeals.

Affirmed.

Before:

Swan, Clark and Frank,
Circuit Judges.

Morris A. Marks, of New York City (Geist & Netter, of New York City, on the brief), for petitioner-appellee.

Irving L. Schanzer, of New York City, for respondent-appellant.

Clark, *Circuit Judge:*

The Prudence Company, Inc., and Prudence-Bonds Corporation, wholly owned subsidiaries of the same parent corporation—New York Investors, Inc.—were together engaged in the mortgage-guaranty business. By a common practice, Prudence would lend money on a bond and real property mortgage, which it would assign to Prudence-Bonds. The latter would place them with a public depository and would issue certificates authenticated by the depository of undivided shares of specified amounts in the bond and the mortgage. These certificates would then be sold to the public with Prudence's guarantee attached. The practice is described in *In re The Westover, Inc.,* 2 Cir., 82 F. 2d 177, and see, also, *In re Prudence Co., Inc.,* 2 Cir., 89 F. 2d 689; *In re Prudence Co., Inc.,* 2 Cir., 98 F. 2d 559, *certiorari* denied 306 U. S. 636, 59 S. Ct. 485, 83 L. Ed. 1037; *In re Prudence Bonds Corp.,* 2 Cir., 79 F. 2d 212.

This procedure was followed in connection with the issue here involved. Prudence having lent the Zo-Gale Realty Co., Inc., $480,000, the loans were consolidated in 1925 in one bond secured by mortgage of the premises at 202 Riverside Drive, New York City. Prudence immediately assigned

the bond and mortgage to Prudence-Bonds, which deposited them with Central Union Trust Company of New York and sold to the public certificates guaranteed by Prudence to the amount of $382,800. The mortgage was thereafter reduced by payment to $390,000. In 1932, Prudence repurchased two certificates in the amount of $800, and otherwise became entitled to one in the amount of $16.67. Whether claims in reorganization proceedings on these certificates totalling $816.67 and on the uncertificated balance of the loan, to wit, $7,200, stand on a parity with, or are subordinated to, the claims of general certificate holders is the question here at issue.

In proceedings for the foreclosure of a mortgage junior to the one received by Prudence, following the mortgagor's default, the property was transferred February 1, 1933, subject to Prudence's mortgage, to Amalgamated Properties, Inc., a subsidiary of Prudence. Reorganization proceedings against Prudence were begun February 1, 1935, and against Amalgamated, March 16, 1936. By an order therein of January 28, 1938, the court approved a transfer by Prudence-Bonds, also in reorganization, to the Prudence trustees of the $7,200 uncertificated portion of the Zo-Gale mortgage, in compromise of other claims. A plan for the reorganization of the Zo-Gale issue was subsequently confirmed, February 19, 1938, and pursuant thereto, title to the mortgaged property was transferred to Geist, petitioner herein, to carry out the plan.

The order of confirmation did not settle, however, the question which had been raised regarding the right of the Prudence trustees to satisfaction of their claims on a parity with other certificate holders. By Paragraph 7 thereof, Geist was forbidden to make distribution of cash or securities on account of these claims unless their right thereto had "been finally adjudicated by a court of competent jurisdiction," and by Paragraph 30, the court retained in itself jurisdiction to decide the question.

Respondent, Prudence Realization Corporation, which succeeded to the interest of the Prudence trustees following the reorganization of Prudence by an order of May 26, 1939, now opposes Geist's petition for subordination of the claims. The court below held, however, that under New York law a guarantor of mortgage certificates who also has an interest in the mortgage cannot share in the collateral until the certificate holders are paid, unless there is a clear reservation in the certificate of a right to share on a parity. Respondent has appealed from the resulting order of subordination against it.

The New York law to which the district court refers has been established in a series of recent cases dealing with the liquidation of companies engaged in the guaranteed mortgage business. *In re Union Guarantee & Mortgage Co.,* 285 N. Y. 337, 34 N. E. 2d 345; *Pink* v. *Thomas,* 282 N. Y. 10, 24 N. E. 2d 724; *In re Title & Mortgage Guaranty Co. of Sullivan County,* 275 N. Y. 347, 9 N. E. 2d 957, 115 A. L. R. 35, and other cases cited in these decisions. An important issue herein is whether this is primarily a rule of construction of the guaranty in the certificates or is a rule of administration of insolvent estates which violates bankruptcy principles of equal distribution of a bankrupt estate among creditors. If it is a rule of construction, we would follow it as we held in *In re Prudence Co., Inc.,* 2 Cir., 82 F. 2d 755, *certiorari* denied 298 U. S. 685, 56 S. Ct. 958, 80 L. Ed. 1405; and see, of course, *Erie R. Co.* v. *Tompkins,* 304 U. S. 64, 58 S. Ct. 817, 82 L. Ed. 1188, 114 A. L. R. 1487. And if we thus found the guarantee to amount to an actual agreement between two creditors that the claim of one against the debtor should be subordinated to that of the other, we should give that effect to it, as was done in *St. Louis Union Trust Co.* v. *Champion Shoe Machinery Co.,* 8 Cir., 109 F. 2d 313; *Bird & Sons Sales Corp.* v. *Tobin,* 8 Cir., 78 F. 2d 371, 100 A. L. R. 654; and *Searle* v. *Mechanics' Loan & Trust Co.,* 9 Cir., 249 F. 942, *certiorari* denied 248 U. S. 592, 39 S. Ct. 67, 63 L. Ed. 437, even though there ap-

pears to be authority contra to the effect that the enforcement of such agreements, not amounting to assignment of a claim, is entirely collateral to the interests of the estate and outside the bankruptcy power. *In re Railroad Supply Co.*, 7 Cir., 78 F. 2d 530; *In re Goodman-Kinstler Cigar Co.*, 32 A. B. R. 624; see *Nixon* v. *Michaels*, 8 Cir., 38 F. 2d 420. Where the state law determines what the actual agreement made by the parties is, and therefore the real basis of their claims in bankruptcy, it must be given effect.

If, however, the matter is one of insolvent liquidation only, we have a different situation. It is a necessary implication of the requirement of a plan of reorganization that "it is fair and equitable and does not discriminate unfairly in favor of any class of creditors," Bankruptcy Act, former §77B(f)1, as it is a corollary of the strict priorities rule of *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 60 S. Ct. 1, that a plan may not discriminate between different members of the same class of creditors or classify creditors arbitrarily, without due regard to their economic status as defined in their respective claims. See *Southern Pacific Co.* v. *Bogert*, 250 U. S. 483, 492, 39 S. Ct. 533, 63 L. Ed. 1099; 49 Yale L. J. 881, 882; 2 Gerdes, Corporate Reorganizations, 1682; Finletter, Bankruptcy Reorganization, 465. Similarly, Bankruptcy Act, §65a, requires, in liquidation, the distribution of "dividends of an equal per centum" "on all allowed claims, except such as have priority or are secured." *Moore* v. *Bay*, 284 U. S. 4, 52 S. Ct. 3, 76 L. Ed. 133, 76 A. L. R. 1198; *Globe Bank & Trust Co.* v. *Martin*, 236 U. S. 288, 305, 35 S. Ct. 377, 59 L. Ed. 583; *Sampsell* v. *Imperial Paper & Color Corp.*, 61 S. Ct. 904, 907. The only departures made from the ordinary rule of equality are based on some very definite equity, such as fraud, *Pepper* v. *Litton*, 308 U. S. 295, 60 S. Ct. 238, 84 L. Ed. 281, mismanagement of the debtor by a parent corporation, *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307, 59 S. Ct. 543, 83 L. Ed. 669, or concealment of a claim to the prejudice of another creditor, *In re Bowman Hardware*

& Electric Co., 7 Cir., 67 F. 2d 792. In the absence of such an equity, subordination is not a function of the bankruptcy court. *Crowder* v. *Allen-West Commission Co.*, 8 Cir., 213 F. 177, 184; *Sampsell* v. *Imperial Paper & Color Corp., supra; cf. Moise* v. *Scheibel*, 8 Cir., 245 F. 546.

Notwithstanding the antithesis thus stated, the question might still remain somewhat more extensive than whether the New York rule is a mere rule of interpretation. For if it is a rule of law, but one attributing a certain legal result to a contract, that result must still be the basis of the bankruptcy claim—just as, for example, a New York contract of insurance must legally incorporate in itself provisions which may be directly opposed to the parties' actual intent. *American Lumbermen's Mut. Cas. Co.* v. *Timms & Howard, Inc.*, 2 Cir., 108 F. 2d 497, 502. It is still the difference between finding out what the contract claim is as opposed to adjusting priorities among ascertained claims. But, however far the answer to such a question might take us, we need not determine it here, for the New York decisions emphasize that it is the intent of the parties which they are seeking to ascertain with the aid of a "presumption of intent derived from the guaranty of the assignor." The language just quoted is from *In re Title & Mortgage Guaranty Co. of Sullivan County, supra*, where the present Chief Judge has made the most extensive analysis of the subject of any of the cases and where he discusses not merely New York, but general, precedents. He finds that the rule "is supported by the weight of authority in this and other jurisdictions and produces an equitable result in accordance with the intent of the parties," that "the decisive test in every case is the intention of the parties, either as actually expressed, or as derived from the natural equity of the situation," and that "a presumption of such intent is derived from special equities," of which the guaranty seems to be the one most noted. 275 N. Y. 353-355. In thus stating the basis of the rule he expressly eliminates "avoidance of

circuity of action" as its basis in this State; and he holds that the mere assignment of part of the mortgage without any guaranty is insufficient to raise a presumption against parity, citing *Title Guarantee & Trust Co.* v. *Mortgage Commission,* 273 N. Y. 415, 428, 7 N. E. 2d 841, 847, where such an assignment was held to permit the assignor to share *pro rata* with the assignee in the proceeds of insufficient surety. The most recent cases have followed the same principle; indeed, in the latest case of all, *In re Union Guarantee & Mortgage Co., supra,* certain language of the depository agreement was assumed to be adequate to achieve such parity but for the fact that the guarantor had cancelled its acquired certificates and had not issued others in place of them.

There is considerable authority in other jurisdictions to similar effect. *In re Phillippi,* 329 Pa. 581, 198 A. 16; *Appeal of Fourth Nat. Bank,* 123 Pa. 473, 16 A. 779; *Donley* v. *Hays,* 17 S. & R., Pa., 400; *Worrall's Appeal,* 41 Pa. 524; *Fidelity Trust Co.* v. *Orr,* 154 Tenn. 538, 289 S. W. 500; and see, also, *Whitehead* v. *Morrill,* 108 N. C. 65, 12 S. E. 894; *Cannon* v. *McDaniel,* 46 Tex. 303; *Dixon* v. *Clayville,* 44 Md. 573. The leading authority to the contrary is *Kelly* v. *Middlesex Title Guarantee & Trust Co.,* 115 N. J. Eq. 592, 171 A. 823, affirmed 116 N. J. Eq. 574, 174 A. 706, much relied on by respondent herein. The reasons assigned for the rule have varied between the effect of the guaranty as evidence of an intent to grant the assignees priority, as in the Pennsylvania and Tennessee cases cited, or, as in *Dixon* v. *Clayville* and apparently the two cases cited before it, to avoid a circuity of action in suits by the general creditors against the guarantor—a reason, as is pointed out in the *Kelly* case, which loses its force where the guarantor is insolvent. A vigorous criticism of the rule as applied to an insolvent assignor appears in 47 Yale L. J. 480-483, where it is pointed out that the rule may give the assignees a preference at the expense of unsecured creditors, and, in the case of a large holding of a single issue, prejudice other

customers of the assignor in favor of the holders of this particular issue. Compare, also, 37 Col. L. Rev. 1010; 34 Col. L. Rev. 663, 678; 14 N. Y. U. L. Q. Rev. 259; 19 R. C. L. 659, 660. In these comments it appears to be assumed that the rule is one of intent or construction of the guaranty.

Whether or not we might quarrel with the rule as an original or a general proposition, we see no occasion to do so here. Creditors of different New York mortgage-guaranty companies ought to receive similar treatment, without respect to the tribunal in which liquidation occurs, for certainly their respective investments were made under substantially identical conditions. Moreover, there appear to be no particular equities in favor of either the original guarantor or those who claim through it, including its successor, the respondent herein, which took with full notice of the situation from the reorganization proceedings generally and especially in view of the explicit reservation of the question in the confirmation of the debtor's reorganization. After all, all parties to these proceedings, guarantor, mortgagee, and debtor, are interconnected companies; and as a matter of practical equity so far as the public purchasers of certificates are concerned, it is only just that their mutual claims among each other should be subordinated until the claims of their customers have been satisfied. Moreover, the wording of the contracts here is such as to indicate an intent that the guarantor should not have parity with the others. For the agreement with Prudence-Bonds provides that it "may for its own corporate account, be the holder or pledgee of similar shares in said bond and mortgage," whereas in Prudence's guaranty such a provision is almost pointedly lacking. Under *Pink* v. *Thomas*, *supra*, an actual agreement against parity might well be found.

A final question arises as to the claim on the uncertificated indebtedness of $7,200, for that, at the time of the debtor's bankruptcy, was nominally in the name of Prudence-Bonds, which, in the light of the agreement just

quoted, as well as *Title Guarantee & Trust Co.* v. *Mortgage Commission, supra,* would itself be entitled to share on a parity with the certificate holders, since it was not a guarantor. But the record shows without dispute that Prudence-Bonds when it took the original assignment from Prudence did not give any money value for the bond and mortgage and could not be expected to, as it had no such assets as would justify a loan in its own right of this amount. Compare *In re The Westover, Inc., supra; In re Prudence Bonds Corp., supra.* And later collections of interest applicable to this uncertificated indebtedness went to Prudence. On the basis of such facts appearing of record the court below held that Prudence was the actual and equitable owner throughout, and hence the New York rule was applicable. We think this conclusion sound and in accordance with the undoubted realities of the relations between the parties here. On this basis both the uncertificated portion of the indebtedness and the certificates bought by Prudence prior to any of the reorganization proceedings were properly declared subordinate to the claims of the public certificate holders.

Affirmed.

Frank, *Circuit Judge,* dissents with opinion.

Frank, *C. J.*, dissenting:

There are two factual aspects of this case to which, I think, the majority has given insufficient attention:

(1) Prudence, the guarantor, itself is bankrupt. Its creditors are all general creditors, i.e., holders of certificates of several different issues (including the Zo-Gale issue) which Prudence had guaranteed, their claims all being based on the obligations of Prudence on those guarantees. Among the assets of the Prudence estate are the Zo-Gale certificates held by Prudence. The majority, by subordinating Prudence's claim in the Amalgamated proceedings, is thus preferring the claims of one group of Prudence's general creditors—the holders of the Zo-Gale certificates—to those of Prudence's other general creditors, i.e., the holders of other certificates guaranteed by Prudence, by giving assets to the Zo-Gale holders which would otherwise be divided among all of Prudence's general creditors.

(2) If the certificates which are the basis of Prudence's claim against Amalgamated had not been repurchased from their holders by Prudence,[1] or if certificates had been issued against the uncertificated interest here involved and had been sold to the public, the holders of those certificates could have proved them, in the reorganization of Amalgamated, on a parity with the Zo-Gale certificates which are now, in fact, so held by the public. It is only because of the fortuitous circumstances that Prudence, under conditions which no one even intimates were improper, repurchased the certificates and failed to sell, of its own choice, the uncertificated interest, that the public holders of the Zo-Gale issue claim that they are entitled to a larger share of the

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1 Or if they had again been resold, before the reorganization, to the public.

available assets than they would have received if all the certificates were publicly owned.

Those facts are, to my mind, controlling: As the majority points out, the usual federal rule of bankruptcy administration would require that Amalgamated's assets should be equitably distributed, without such a preference, among all claimants, Prudence[2] as well as the public certificate holders. I am satisfied to take as my text the majority's words: "The only departures made from the ordinary rule of equality are based on some very definite equity. * * * In the absence of such an equity, subordination is not a function of the bankruptcy court." I search in vain both the record and the majority opinion to find any evidence of such an equity. I find, rather, that the preference is markedly inequitable. There is also the striking fact that the entire case for subordination rests upon the mere accidental repurchase of the certificates; because of this adventitious fact, subordination is a windfall to the other holders of the Zo-Gale certificates, and the other creditors of Prudence—which, so far as appears, retained the uncertificated interest and repurchased the certificates solely as an investment, and held them in place of either cash or other securities—find the assets of Prudence depleted.

The only equity suggested by the majority opinion to justify the preference is that the companies are interconnected so that "it is only just that their mutual claims among each other should be subordinated until the claims of their customers have been satisfied." I am unable to follow that reasoning. This is not at all a case of a parent company asserting a creditor claim against an insolvent subsidiary which it had organized and/or operated for its

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2 Hereafter I shall, for convenience, treat the uncertificated portion of the mortgage as identical with the repurchased certificates; as the majority points out, Prudence was the true owner of both.

own benefit, as in *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307 and related cases.[3] There is no suggestion that Prudence interfered in the affairs of Zo-Gale Realty Company or mismanaged it, but merely made it, an autonomous entity, a loan for which Prudence received a bond and mortgage, some participation certificates in which Prudence sold to others, with a guarantee.

The majority opinion makes an additional argument: Appellant, it says, "took with full notice of the situation" because the issue of subordination was reserved in the Zo-Gale reorganization proceedings. But that sort of notice is inefficacious to create equities: Appellant represents the interests of Prudence's creditors; it was created long after they became creditors; they became creditors without any such notice; that notice served merely to keep open for future decision the question, first raised in the Zo-Gale proceedings, of whether, because of facts previously occurring, there should be a subordination.

Since I am unable to find "some very definite equity" in favor of subordination—in the absence of which, as the majority opinion says, "subordination is not a function of the bankruptcy court"—I would follow the normal principle of bankruptcy administration, that "equality is equity". So far as the New York rule applies to a situation where the guarantor is itself solvent, I regard it as both fair and practicable, and see no reason why the federal courts should not adopt it.[4] But *it becomes a totally different rule when, as here, the guarantor itself is a bankrupt; then the problem which confronts the federal courts is one of equitable*

3 Were the facts of this case such as to bring it within the general outlines of the rule of the *Taylor* case, *supra*, we would be obliged to consider the significance of the cautionary comments in *Consolidated Rock Products Co.* v. *DuBois*, —— U. S. —— (March 3, 1941).

4 In such a situation, the federal courts are bound by the decisions of the New York courts as to whether language in the contract has the effect of overcoming the New York rule as to subordination, for such decisions relate to the intention of the parties to the contract.

distribution, under the Bankruptcy Act, of the insufficient proceeds of a guaranteed obligation among all the guarantor's creditors, including the assignees of a portion of the guaranteed obligation.

The majority opinion seems to imply, however, that, under *Erie* v. *Tompkins,* 304 U. S. 64, we are not free to apply the rules generally applicable in federal bankruptcy decisions because subordination is required by the New York decisions as to the *intention of the parties* to such contracts. But I do not read the New York decisions as holding that subordination, in such a case as this, results from the intention of the parties. As I understand those decisions, they say that, in such a case, subordination is an equitable rule of administration in the distribution of the primary obligor's assets among an insolvent guarantor and its assignee-creditors. The preference is granted even when, as in the case at bar, there is no evidence of any kind—in the verbiage of the contract or otherwise—that the parties had any actual intention to create or not to create one.[5] Absent any evidence of such an intent, the New York Court, nevertheless, sustains such a preference as against the other creditors of the insolvent guarantor on the basis of what that Court calls "the existence of special equities" arising solely from the guaranty. *Matter of Title & Mortgage Guaranty Co.,* 275 N. Y. 347, 355; *Title Guarantee & Trust Co.* v. *Mortgage Commission,* 273 N. Y. 415, 426; *New York Trust Company* v. *United Equities,* N. Y. L. Journal, June 12, 1941. Reference is also made to "the implied or actual intent of the parties;" *Pink* v. *Thomas,* 282 N. Y. 10, 15; *Granger* v. *Couch,* 86 N. Y. 484; "implied" is significantly differentiated from "actual" intent and thus means intent "implied in law", i.e., not intent at all. And

5 In some of the cases decided by the New York court, it found language in the contract showing an actual intention to create a preference. But in the case at bar there is not a vestige of such language.

the same is true of the locution in some of the above cases as to a "presumption of intent" as distinguished from the "actual intent." In *Pink* v. *Thomas, supra* (p. 12), the court states the basis of the rule thus: "Having guaranteed the payment of the certificates it would be highly *inequitable* to permit it (the guarantor) to step in and divert part of the security available to pay such certificate holders whom it had expressly guaranteed should be paid;" the guarantor may hold on a parity, if the contract clearly shows that the parties intended it; but "such an *inequitable result* could be accomplished if the language used was so clear and unmistakable that the courts would be compelled to give effect to the intent of the parties as expressed in the writing. Otherwise the *equitable rule* should apply."[6] That is not the verbiage which the New York court would employ if it were determining that the parties had an actual intention, expressed in their contract, to create a preference; but it is verbiage appropriate in spelling out a rule of insolvency administration. And my brother judges concede that *Erie* v. *Tompkins* does not require us to adopt such a rule.

A contrary argument (implied in the majority opinion here) runs thus: If a contract relating to the sale of a guaranteed obligation contains an express provision showing a clear intention to negate the New York subordination rule, such a provision is given effect by the New York courts; consequently the failure to insert such an express negating provision in the contract is the equivalent of intentionally inserting an express provision adopting the New York rule of administration of the guarantor's insolvent estate; therefore, where, as here, no such negating clause was included, we are not substituting the New York rule of insolvency distribution for the federal bankruptcy rule, but are compelled to apply an actual provision of the contract which is

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6 Italics added.

implied in fact. That argument proves too much; it amounts to saying that parties to a contract are always to be deemed actually to intend to include in their contract any rule of law which they could, by contract, nullify, but which they do not. Such an argument, too, rests on a fiction; and fictions should be sparingly employed and never utilized to bring about unjust results. *United States* v. *Bags of Coffee,* 8 Cranch. 398, 415; *Helvering* v. *Stockholm Bank,* 293 U. S. 84, 82; *Curry* v. *McCanless,* 307 U. S. 357, 374.

Even if the majority opinion were correct in suggesting that the New York courts have said that their rule is not one of insolvency administration, but one of interpretation of the intention of parties to this kind of contract, I would still dissent. For I cannot believe that what, by its nature, is a rule of administration of insolvent estates can be transformed into such a rule of interpretation—and that, therefore, it becomes binding on the federal courts merely because of the label attached to the rule by the State Court. To illustrate: In applying the doctrine of *Taylor* v. *Standard Gas & Electric Co., supra,* the Supreme Court did not look to the decisions of the State Court. If the courts of that State were hostile to the rule of the *Taylor* case, and (taking a hint from the majority opinion in the instant case) were to say that it construes contracts made by creditors with a subsidiary corporation as showing an intention to exclude the rule of the *Taylor* case unless expressly contracted for, I doubt whether the Supreme Court would, simply on that account, refuse to apply that rule. In other words, I doubt whether *Erie* v. *Tompkins* is so cannibalistic.

And my doubt is especially strong where the rule of the State Court is squarely contrary to the federal rule under the federal Bankruptcy statute and where federal jurisdiction is founded upon that statute. If the majority opinion is correct, *Erie* v. *Tompkins* is likely soon to break up such uniformity of federal decisions as now exists relative

to federal bankruptcy administration. What will then become of the provisions of the Constitution which authorizes Congress to enact "*uniform* laws on the subject of bankruptcies throughout the United States?" Surely respect for State's rights should not be carried that far. It has never suggested that statutes enacted under the interstate commerce or admiralty clauses must be given varying applications responsive to divergent State decisions; yet those clauses of the Constitution, unlike that relating to bankruptcies, make no explicit mention of laws which are to be "uniform * * * throughout the United States." *Erie* v. *Tompkins,* according to some of the Justices who joined in it, repudiated the rule of *Swift* v. *Tyson* on the ground that rule, in so far as it permitted the federal courts to ignore State court decisions, was unconstitutional; but no one would venture to deny to Congress the power to provide that, generally, uniformity and not variety should govern in bankruptcy; and such congressional intention should be presumed in the light of the express wording of the bankruptcy clause.

Related considerations are pertinent with respect to the suggestion in the majority opinion that, even if we are free to ignore the New York rule, we should not do so, since, thereby, persons in similar circumstances, *vis a vis* an insolvent guarantor, will be treated differently by State and federal tribunals. Such an argument is self-defeating: No doubt uniformity between State and federal courts is desirable; but so is nationwide uniformity of bankruptcy administration; if the majority opinion assists in establishing the first of these, it helps to destroy the second. Where a paramount public policy does not demand it, I can see no reason for our going out of our way to transplant, from the State to the federal courts, a doctrine which is so curiously lacking in logic and fairness as the New York rule of automatic subordination.

Although not considered in the majority opinion, there is this further possible argument to sustain the preference: It might conceivably be argued that the rule of the New York court had the effect of creating an equitable lien in the Zo-Gale mortgage, in favor of the public certificate holders, i.e., that, in effect, the guaranty, from its inception, gave them a first lien on that mortgage. But the New York court nowhere suggests that its rule is to be taken as creating such an equitable lien, in all likelihood because the existence of such a lien cannot be reconciled with the fact that, under the New York decisions, the guarantor, with entire legality, can destroy it at any time, by merely selling the unissued or repurchased certificates without the consent of the holders of the then outstanding publicly held certificates.[9]

9 Such a "lien" would not rise even to the dignity of an unrecorded chattel mortgage. It may also be noted, in passing, that the rights of the Trustees in bankruptcy of Prudence vested before Amalgamated went into bankruptcy.

Order for Mandate.

UNITED STATES CIRCUIT COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Circuit Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 29th day of August, one thousand nine hundred and forty-one.

Present: HON. THOMAS W. SWAN,
HON. CHARLES E. CLARK,
HON. JEROME N. FRANK, *Circuit Judges.*

IN THE MATTER
OF
THE PRUDENCE COMPANY, INC.,
Debtor,

PRUDENCE REALIZATION CORPORATION,
Appellant.

Appeal from the District Court of the United States for the Eastern District of New York.

This cause came on to be heard on the transcript of record from the District Court of the United States for the Eastern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is affirmed with costs.

It is further ordered that a Mandate issue to the said District Court in accordance with this decree.

D. E. ROBERTS,
Clerk.

UNITED STATES CIRCUIT COURT OF APPEALS

Second Circuit

In the Matter

of

The Prudence Company, Inc.,
Debtor,

Prudence Realization Corporation,
Appellant.

ORDER FOR MANDATE

United States Circuit Court of Appeals
Second Circuit

Filed August 29, 1941

D. E. Roberts, Clerk.

Clerk's Certificate.

UNITED STATES OF AMERICA

SOUTHERN DISTRICT OF NEW YORK

I, D. E. ROBERTS, Clerk of the United States Circuit Court of Appeals for the Second Circuit, do hereby certify that the foregoing pages, numbered from 1 to 75, inclusive, contain a true and complete transcript of the record and proceedings had in said Court, in the case of

IN THE MATTER

OF

THE PRUDENCE COMPANY, INC.,
Debtor,

PRUDENCE REALIZATION CORPORATION,
Appellant.

as the same remain of record and on file in my office.

(Seal) IN TESTIMONY WHEREOF, I have caused the seal of the said Court to be hereunto affixed, at the City of New York, in the Southern District of New York, in the Second Circuit this seventeenth day of September, in the year of our Lord one thousand nine hundred and forty-one, and of the Independence of the said United States the one hundred and sixty-sixth.

D. E. ROBERTS,
Clerk.

[fol. 77] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed January 5, 1942

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Roberts took no part in the consideration and decision of this application.

(8512)

NOV 24 1941

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

IN THE MATTER
OF
THE PRUDENCE COMPANY, INC.,
Debtor.

IN THE MATTER
OF
AMALGAMATED PROPERTIES, INC.,
Debtor.

IN THE MATTER
OF
A Plan of Reorganization of AMALGAMATED PROPERTIES, INC., Debtor, in respect of the ZO-GALE FIRST MORTGAGE PARTICIPATION CERTIFICATES.

PRUDENCE REALIZATION CORPORATION,
Petitioner,

A. JOSEPH GEIST, Trustee,
Respondent.

In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act.

Nos. 27496 and 27028.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

IRVING L. SCHANZER,
Counsel for Prudence Realization Corporation, Petitioner.

INDEX

TABLE OF CASES

STATUTES

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No.

IN THE MATTER OF THE PRUDENCE COMPANY, INC., Debtor. --- IN THE MATTER OF AMALGAMATED PROPERTIES, INC., Debtor. --- IN THE MATTER OF A Plan of Reorganization of AMALGAMATED PROPERTIES, INC., Debtor, in respect of the ZO-GALE FIRST MORTGAGE PARTICIPATION CERTIFICATES. --- PRUDENCE REALIZATION CORPORATION, Petitioner, A. JOSEPH GEIST, Trustee, Respondent.	In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act. --- Nos. 27496 and 27028.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable the Chief Justice of the Supreme Court of the United States of America and the Honorable Associate Justices thereof:

Your petitioner, Prudence Realization Corporation, respectfully submits this, its petition for a writ of certiorari to review the decision and order of the United States Circuit Court of Appeals for the Second Circuit in the above cause affirming the order of the District Court determining that certificates of participation and other interests held by Prudence Realization Corporation (hereinafter sometimes described as the creditors corporation) in a mortgage participation certificate issue covering premises (an apartment house) at No. 202 Riverside Drive, New York City, also known as the Zo-Gale Certificate Issue, are subordinated in time of payment of principal and interest to similar certificates of participation held by the other certificate holders.

Opinions Below

Written opinions have been rendered by the District Court (R. 46-48 *, not yet reported) and by the Circuit Court of Appeals for the Second Circuit, reported at 122 F. (2d) 503.

Jurisdiction

The decree of the Circuit Court of Appeals was entered on August 29, 1941 (R. 74-75). The jurisdiction of this Court is invoked under Section 240a of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A., Sec. 347-a).

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* The record consists of a Transcript of Record and a Transcript of Additional Record. The additional record is composed of exhibits annexed to the original answering affidavit filed in the District Court (R. 35). An order was secured from the Circuit Court of Appeals dispensing with the requirement that these exhibits be printed as part of the record on appeal. Copies were submitted to the Court upon the argument of the appeal, and have here been printed as the Additional Record. Record references in the within petition are made to the main record as "R. ....", and to the Additional Record as "Add. R. ....".

Questions Presented

The majority of the Circuit Court of Appeals held the decisions of the New York Court of Appeals controlling on the issues presented on this appeal and accordingly decided that the interests of Prudence Realization Corporation are subordinate in time of payment to those of the other certificate holders. The Court also held that, despite the fact that preferences unauthorized by the Bankruptcy Act would result, the New York rule of distribution should be applied here so that creditors of all insolvent New York mortgage guarantee companies should receive similar treatment without regard to the tribunal in which the proceeding for the liquidation of any such guarantor took place. The principal questions involved are:

(1) Was the Circuit Court of Appeals, under the decision of this Court in *Erie R. Co.* v. *Tompkins,* 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188, obliged to follow the decisions of the New York Court of Appeals even though the adoption of the rule of distribution established by such decisions results in restricting the equitable power of the bankruptcy court to classify creditors' claims for purposes of distribution under the Bankruptcy Act?

(2) Did the Circuit Court of Appeals, in following the state court decisions, improperly impose a restriction upon the equitable powers of the bankruptcy court to classify creditors' claims?

(3) Did the Circuit Court of Appeals properly impose upon the remaining unsecured creditors of an insolvent guarantor the burden of showing that the granting of priority to other unsecured creditors of the same insolvent would be inequitable?

(4) Was the Circuit Court of Appeals justified in granting preferential rights to certain creditors of the insolvent guarantor, after the confirmation of a

creditors' plan of reorganization for the guarantor-debtor under Section 77B of the National Bankruptcy Act, where such plan did not provide for such preference and where such creditors were not separately classified?

Statement

The Prudence Company, Inc., hereafter called "Prudence", was organized under the Banking Law of the State of New York in 1919. It was engaged in the business of making loans secured by mortgages on real estate. The bonds and mortgages received for such loans were assigned to an affiliated corporation, Prudence-Bonds Corporation, the stock of which was owned by New York Investors, Inc., which also owned all of the common stock of Prudence (R. 22). Prudence-Bonds Corporation transferred these bonds and mortgages to corporate trust companies, called depositaries, and issued certificates of participation in such mortgages to Prudence, which in turn sold them to the general public together with its guaranty of payment of principal and interest (R. 22). These mortgage participation certificates constituted the holders thereof tenants in common of the underlying mortgage and bond secured thereby (*In re Westover* [C. C. A. 2d] 82 F. [2d] 177).

In the course of its business, from time to time Prudence either repurchased some of these certificates from the investing public, or received them in exchange for certificates in other mortgages. The certificates on hand, either prior to sale to the public or upon reacquisition, were included in the corporate assets of Prudence as evidenced by published financial statements and corporate balance sheets prepared by certified public accountants (R. 24). It was the intention of Prudence, in each instance upon the acquisition of the aforementioned certificates, to hold them as investments, and not in cancellation or payment of its guarantee obligation (R. 24).

Prudence Realization Corporation, the petitioner here, was organized pursuant to a plan of reorganization for Prudence under Section 77B of the Bankruptcy Act (Add. R. Ex. "D"). The plan was proposed by Reconstruction Finance Corporation, the largest single creditor of Prudence, after a finding had been made that Prudence was insolvent. The plan provides that the stockholders of Prudence have no interest in the liquidation of its assets, and provides for the distribution of the proceeds of such liquidation to creditors only (Add. R. Ex. "D" Plan, p. 9). Petitioner is therefore solely a creditors' realization corporation and in no way represents interests of the old stockholders.

The Zo-Gale Certificate Issue was created in the manner above described. The mortgage, originally in the principal amount of $480,000, was reduced by payment by the mortgagor to $390,000. Certificates to the extent of $382,800 are now outstanding. Included in the assets of the insolvent Prudence estate transferred to petitioner are $816.67 in principal amount of Zo-Gale certificates which were repurchased by Prudence in 1932 for full value (R. 23-24). The remaining $7,200 interest in the mortgage, against which no certificates were issued, is now also held by petitioner, and was acquired by the Prudence Trustees in the manner and under the conditions hereinafter described (R. 26-27).

In January, 1935, an involuntary petition for the reorganization of Prudence under Section 77B of the Bankruptcy Act was filed in the Eastern District Court and on February 1, 1935, the petition, consolidated with the debtor's voluntary petition for reorganization was approved and trustees appointed. An order was entered in that proceeding prescribing the procedure for the filing of proofs of claim by creditors, including certificate holders of the Zo-Gale Issue, who were unsecured creditors of the debtor (R. 26). In these proofs of claim, certificate holders asserted unsecured claims for the full principal and interest due on the Prudence guaranty of the certifi-

cates held by them (Add. R. Ex. "B"), and they were allowed as such.

Included in the assets of the Prudence estate were a substantial number of obligations of Prudence-Bonds Corporation, which was being reorganized in the same court. A dispute arose as to the participation of the Prudence interest in the creditors' plan of reorganization for Prudence-Bonds Corporation. The dispute was compromised and as part of the adjustment it was agreed that the Prudence-Bonds Corporation Trustees would transfer the uncertificated interest in the certificate issues of Prudence-Bonds Corporation, including the $7,200 interest in the Zo-Gale mortgage, to the Prudence Trustees, subject, however, to claims of general creditors of Prudence-Bonds Corporation (R. 26-27).

On March 16, 1936, pursuant to authorization secured in the Prudence proceeding, the petition for reorganization of Amalgamated Properties, Inc., as a subsidiary of Prudence, was approved by the Eastern District Court (R. 27-28). Included among its assets was the real property subject to the Zo-Gale Certificate Issue mortgage and in that proceeding a plan of reorganization for that issue was proposed which provided for the transfer of the real property by Amalgamated to a Trustee appointed for certificate holders, who also pursuant to said plan acquired the certificated mortgage. The lien of the mortgage was preserved for the benefit of all the certificate holders, who also became co-owners of the real estate. That plan of reorganization for the Zo-Gale Issue, as amended, was finally approved by the District Court on February 19, 1938, and the property, together with the entire outstanding mortgage, was transferred to A. Joseph Geist, Trustee, appellee herein (R. 10-11).

Included in that plan of reorganization and in the order of confirmation was a provision that the rights of the certificates owned by Prudence to share on a parity with those held by the other certificate holders were left open or reserved for future judicial determination. This pro-

vision also related to the uncertificated interest or share, and the 77B Trustees of Prudence consented to the plan of reorganization so as to permit the transfer of administration to certificate holders (R. 12).

Throughout the proceedings above described, from February 1, 1935, Prudence was in reorganization and in 1938 a creditors' plan of reorganization for Prudence was proposed by Reconstruction Finance Corporation, its most substantial creditor. *The order confirming the plan determines that there are no claims having priority except tax claims and claims for administration expenses* (Add. R. Ex. "D", Order, p. 13). Copies of that plan of reorganization were forwarded to every holder of a guaranty claim as well as other creditors of Prudence. Included in the guaranty claimants were the certificate holders in the Zo-Gale Issue. Throughout the period of consideration of the plan of reorganization, no claim was ever asserted in the Prudence proceeding on behalf of any Zo-Gale certificate holders to priority in distribution, nor was any claim made in that proceeding that by reason of the default by Prudence on its guaranty of the Zo-Gale certificate, the certificates held by Prudence in this issue were to be deemed subordinate to those held by other certificate holders (R. 26, 28). The plan of reorganization for Prudence was approved by the District Court on May 26, 1929, *fifteen months after the Zo-Gale plan was confirmed by the same judge* (R. 29).

In accordance with the provisions of the plan for Prudence, all of the assets of Prudence and its Trustees were transferred and assigned over to petitioner, the creditors' realization corporation, by assignment dated June 1, 1939. Included in those assets were the certificates and uncertificated interest in the Zo-Gale Certificate Issue (R. 11-12). As is set forth in the order confirming the Prudence Plan, there are outstanding obligations of Prudence aggregating $134,123,298.95 (Add. R. Ex. "D", p. 8). Of these claims only the claim of the United States of America for $400,000 has been fully paid.

Prior to the institution of the proceedings for the reorganization of Prudence, and in 1932, all of the stock of Amalgamated Properties, Inc., had been deposited as part of the collateral for a loan made by Reconstruction Finance Corporation to Prudence. In 1938, in accordance with a decision of the Circuit Court of Appeals for the Second Circuit (*In re The Prudence Company, Inc.*, 90 F. [2d] 587) the control and complete ownership of that subsidiary of Prudence passed from the bankrupt estate to Reconstruction Finance Corporation.

Prudence-Bonds Corporation was found insolvent in March, 1937, and a plan of reorganization was confirmed which transferred all of its assets to a new corporation for the benefit of its secured creditors. *In re Prudence-Bonds Corporation,* (C. C. A. 2d) 122 F. (2d) 258, 261.

The instant proceeding was instituted by A. Joseph Geist, who was appointed in the Zo-Gale Certificate Issue reorganization trustee of the mortgage d underlying real property. The prayer for relief soug an order determining that the certificates and uncertificated share, now held by petitioner, the creditors' realization corporation, were subordinate to those held by the general public and that no payments of either principal or interest should be made on such certificates or share until other certificate holders had received in full the principal and interest which had been guaranteed by Prudence (R. 12-13).

The District Court held that the rights of the other certificate holders in the Zo-Gale Certificate Issue were superior to those of the other creditors acting through Prudence Realization Corporation and therefore granted the application in all respects. The order entered upon such decision determines, first, that the certificates and share in this issue held by Prudence Realization Corporation for the benefit of all of the Prudence creditors are subordinate to those of the other certificate holders, and second, that no payment shall be made upon such certificates or share to Prudence Realization Corporation "until the third party

certificate holders have been paid in full the principal and interest guaranteed under the certificates held by such third party certificate holders" (R. 50).

The United States Circuit Court of Appeals for the Second Circuit on August 11, 1941, handed down its opinion affirming the decision of the District Court. The affirmance was by a divided court, the majority opinion being written by Circuit Judge Charles E. Clark and concurred in by Circuit Judge Thomas W. Swan and the dissenting opinion being written by Circuit Judge Jerome N. Frank (R. 57-73).

The majority believed the decisions of the New York Court of Appeals on the question of parity to be controlling under the decision of this Court in *Erie R. Co.* v. *Tompkins,* 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188, 114 A. L. R. 1487.

The issue between the parties to this appeal is whether the holders of certificates in the Zo-Gale Issue are entitled to a position of priority as against the other creditors of insolvent Prudence even though the Prudence plan makes no provision for special treatment of claims of these certificate holders or others similarly situated. Petitioner as the creditors' liquidating corporation represents all creditors of Prudence, including the Zo-Gale certificate holders, and the preference authorized by the majority in the Court below is solely at the expense of the remaining creditors. The decision affects $1,096,916 principal amount of certificates of the Zo-Gale and other issues now constituting part of the assets of the Prudence estate, as well as over $300,000 in cash representing interest accumulations to which *all* creditors will be entitled if the decision of the Circuit Court of Appeals is reversed.

Specification of Errors

The Court below erred,

(1) in holding that the certificates of participation in the Zo-Gale Certificate Issue owned by Prudence Realization Corporation are not entitled to parity of distribution with other certificates held by the general public, but are subordinate to the certificates held by others;

(2) in holding that the decisions of the New York Courts determining questions of distribution of an insolvent mortgage guaranty company's assets under State statutes are binding upon the Bankruptcy Court under the authority of *Erie R. Co.* v. *Tompkins;* 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188;

(3) in holding that Prudence Realization Corporation as owner of the uncertificated interest acquired from Prudence-Bonds Corporation in the Zo-Gale mortgage is not entitled to parity of distribution with the other holders of certificates, but is subordinate to such other holders;

(4) in failing to hold that, in accordance with the provisions of the Bankruptcy Act, Prudence Realization Corporation is entitled to share equally with other certificate holders in the proceeds of the Zo-Gale Mortgage Certificate Issue;

(5) in failing to hold that, by the failure of the other holders of Zo-Gale certificates to file claims for priority in the Prudence proceeding or require provision for priority in their favor in the plan of reorganization for Prudence, such holders have waived their rights and may participate only as general creditors without priority or preference as against any other creditors of Prudence.

Reasons Relied On for the Allowance of the Writ

(1). The majority of the Court below has erroneously misconceived the extent to which federal courts are required to follow state court decisions under *Erie R. Co. v. Tompkins*, 304 U. S. 64, 58 Sup. Ct. 817, L. Ed. 1188, 114 A. L. R. 1487, and the decision of the majority is substantially in conflict with the decisions of this Court in *Sampsell v. Imperial Paper & Color Corporation*, 61 Sup. Ct. 904, and *Pepper v. Litton*, 308 U. S. 295, 60 S. Ct. 238, 84 L. Ed. 281. The majority considered itself bound by the decision in *Erie R. Co. v. Tompkins, supra*, to follow the decisions of the New York Courts holding that, in the absence of clear and unambiguous language showing a contrary intent of the parties, public holders of guaranteed mortgage obligations are entitled to priority of distribution in the proceeds of the primary security as against the insolvent guarantor's creditors (R. 62) (122 F. [2d] 503, 506). The basis upon which the decision in *Erie R. Co. v. Tompkins, supra*, was applied by the majority, was that the state court in reaching its conclusion, did so by interpreting the guaranty and the certificates as a contract providing for such subordination.

In his dissenting opinion, Judge Frank demonstrated that the rule established by the state court was not based upon interpretation of any actual provisions of the contract or of any provisions required to be implied from any language in the contract, but was merely a rule of insolvency distribution arbitrarily read into the contract as a matter of law where the contract was silent as to whether parity or priority was intended by the parties. Thus, in arriving at a rule for the distribution of insolvent estates, the New York Courts, in all cases where there is an absence of clear and unambiguous language showing a contrary intent of the parties, indulge in an irrebuttable presumption that the parties to a contract actually intend that other holders of guaranteed mortgage obligations are

entitled to priority of distribution in the proceeds of the primary security as against an insolvent guarantor's creditors.

Erie v. *Tompkins, supra,* does not require the federal courts to follow such state court decisions. Such decisions in reality merely provide state rules for the distribution of insolvent estates and, as Judge Frank correctly stated, are not binding upon federal courts administering assets of insolvent estates under the Bankruptcy Act, which Act provides, as recognized by the majority below, for pro rata distribution. If *Erie* v. *Tompkins, supra,* is to be extended to compel such decisions to be followed by federal courts of bankruptcy, the result will be the imposition of unwarranted restrictions upon the power of the bankruptcy courts to pass upon the proper classification of claims, which this Court has recognized as requiring review by certiorari. *Pepper* v. *Litton,* 308 U. S. 295, 60 S. Ct. 238, 84 L. Ed. 281.

The majority felt obliged to apply the state court decisions even though the rule there prescribed was admittedly in conflict with rules of distribution under the Bankruptcy Act. The issue between the majority and dissenting judges is whether the state court by transforming what is, by its nature, a rule of insolvency distribution, into a rule of interpretation, can oust the federal courts of their exclusive power to administer a bankrupt estate. The principle subscribed to by the majority of the Court below is that the federal courts are bound by the state court's conclusions, even though that Court implies, as conditions of a contract, rules which are in direct conflict with specific provisions of the Bankruptcy Act, or decisions of the federal courts thereunder.

But the federal courts do not even recognize as valid specific provisions of state statutes which in reality create preferences inconsistent with the system of equal distribution established by the federal law. *Jennings, Receiver* v. *United States Fidelity & Guarantee Co.,* 294 U. S. 216,

55 S. Ct. 394, 79 L. Ed. 869, 99 A. L. R. 1248. There the state statute provided that upon insolvency, any item mailed or entrusted to an agent collecting bank for collection but prior to actual collection, shall be returned to the owner and the assets of the bank shall be impressed with a trust in favor of the owner. The insolvent institution involved was a national bank and in an action instituted against its receiver to impress its assets with a trust under the statute, this Court held that the trust would not be recognized. Mr. Justice Cardozo, speaking for this Court, said at page 226:

> "A trust so created, to arise upon insolvency, is a preference under another name. As applied to a national bank, the preference is plainly inconsistent with the system of equal distribution established by the federal law. R. A. § 5236; 12 U. S. C. § 194; *Davis* v. *Elmira Savings Bank*, 161 U. S. 275, 283, 284; *Easton* v. *Iowa*, 188 U. S. 220, 229; *Cook County National Bank* v. *United States*, 107 U. S. 445; *Texas & Pacific Ry. Co.* v. *Pottorff*, 291 U. S. 245; *Lewis* v. *Fidelity & Deposit Co. of Maryland*, *supra* (292 U. S. 449). The power of the nation within the field of its legitimate exercise overrides in case of conflict the power of the states."

There can be no doubt that the same conclusion would have been reached by this Court even if no state statute was involved and the state court judicially had arrived at a determination that the owner was entitled to have a trust impressed.

The legality of a preference arising through state judicial construction is determined, not by the local law creating it, but by the provisions of the federal statute under which it is being enforced. The issue is one for federal determination and is "not influenced by consideration of local law." *Yonkers* v. *Downey, Receiver*, 309 U. S. 590, 597, 60 S. Ct. 796, 84 L. Ed. 964. As Judge Frank said in the instant case (R. 71) (122 F. [2d] at p. 510):

> "In applying the doctrine of *Taylor* v. *Standard Gas & Electric Co.*, *supra*, 306 U. S. 307, 59 S. Ct. 543, 83

L. Ed. 669, the Supreme Court did not look to the decisions of the State Court. If the courts of that state were hostile to the rule of the Taylor case; and (taking a hint from the majority opinion in the instant case) were to say that it construes contracts made by creditors with a subsidiary corporation as showing an intention to exclude the rule of the *Taylor* case unless expressly contracted for, I doubt whether the Supreme Court would, simply on that account, refuse to apply that rule. In other words, I doubt whether *Erie* v. *Tompkins* is so cannibalistic.

"And my doubt is especially strong where the rule of the State Court is squarely contrary to the federal rule under the federal Bankruptcy statute and where federal jurisdiction is founded upon that statute."

Furthermore, under the state court decisions here involved, the burden of showing that it would be inequitable to disallow priority to guaranteed certificates held by others as against certificates held for the benefit of all of the creditors of the insolvent guarantor, is placed upon the representative of all of such creditors. Such a rule is in direct conflict with the decision of this Court in *Sampsell* v. *Imperial Paper & Color Corporation*, 61 S. Ct. 904, where this Court stated at page 904:

> "But the theme of the Bankruptcy Act is equality of distribution. § 65, sub. a, 11 U. S. C. A. § 105; sub. a; *Moore* v. *Bay*, 284 U. S. 4, 52 Sup. Ct. 3, 76 L. Ed. 133, 76 A. L. R. 1198. To bring himself outside of that rule an unsecured creditor carries a burden of showing by clear and convincing evidence that its application to his case so as to deny him priority would work an injustice."

(2) The decision of the Court below has established the principal of uniformity between federal and state courts which has no precedent in any decisions of this Court. The majority has suggested that even if the New York decisions are not binding upon the federal court and are in conflict with the Bankruptcy Act, they should be followed, for creditors of different New York mortgage guaranty com-

panies should receive similar treatment without respect to the tribunal in which the proceedings for the liquidation of the guarantor occurs (R. 64) (122 F. [2d] at p. 507).

This argument ignores the fact that the New York decisions were rendered in connection with the liquidation of such companies under specific statutory provision (New York Insurance Law, Art. XVI), and that the reorganizations referred to in the cited decisions were statutory proceedings ("Schackno Act", New York L. 1933, ch. 745; "Mortgage Commission Act", New York L. 1935, ch. 19).

The adoption of the doctrine suggested by the majority results in judicially permitting the state insolvency laws to supercede the Bankruptcy Act. It transforms the bankruptcy court into a forum in which the administration of the Bankruptcy Act is controlled, not by the Acts of Congress nor by decisions of this Court, but by the statutes or decisions of the state court. Such surrender of federal prerogative in the field of bankruptcy law is without precedent and violates the spirit and intent of the Constitution (Art. I, Sec. 8); *International Shoe Co.* v. *Pinkus*, 278 U. S. 261, 49 S. Ct. 108, 73 L. Ed. 318.

As was stated by Judge Frank, dissenting below (R. 72) (122 F. [2d] 503, 510):

> "Related considerations are pertinent with respect to the suggestion in the majority opinion that, even if we are free to ignore the New York rule, we should not do so, since, thereby, persons in similar circumstances, vis-a-vis an insolvent guarantor, will be treated differently by state and federal tribunals. Such an argument is self-defeating: No doubt uniformity between state and federal courts is desirable; but so is nationwide uniformity of bankruptcy administration; if the majority opinion assists in establishing the first of these, it helps to destroy the second. Where a paramount public policy does not demand it, I can see no reason for our going out of our way to transplant, from the state to the federal courts, a doctrine which is so curiously lacking in logic and fairness as the New York rule of automatic subordination."

(3) The majority of the Court below in determining that other certificate holders are entitled to priority as against the remaining Prudence creditors "as a matter of practical equity", merely relied on the erroneous assumption that there was here involved a consideration of mutual claims between inter-related companies, which therefore justified the conclusion that their customers should receive prior payment (R. 64) (122 F. [2d] at 507). The original relationship between Prudence (the guarantor), Prudence-Bonds Corporation (the mortgagee) and Amalgamated Properties, Inc. (the debtor), to which the majority referred, has been extinguished. Prudence and Prudence-Bonds Corporation, judicially found to be insolvent, have been reorganized separately for the sole benefit of their creditors (Add. R. Ex. D Plan, p. 9; *In re Prudence-Bonds Corporation* [C. C. A. 2d] 122 F. [2d] 258, 261). The creditors of Prudence-Bonds Corporation, who are now its sole owners are also creditors of Prudence. Amalgamated Properties, Inc., is now owned by Reconstruction Finance Corporation, also a Prudence creditor, which accepted the Amalgamated stock as part of the security for a loan to Prudence prior to the date of the acquisition by Prudence of the Zo-Gale certificates here in question. *In re The Prudence Company, Inc.*, (C. C. A. 2d) 90 F. (2d) 587.

The issue here therefore remains one solely between creditors of Prudence and not between inter-related corporate entities, and to use the majority's own words, "as a matter of practical equity", all of such creditors should receive similar treatment without priority or preference in favor of one as against the others, particularly where as here, the holders of Zo-Gale certificates who have been granted priority, are also guaranty creditors, entitled to share in the distribution of the assets of petitioner.

CONCLUSION

Wherefore, it is respectfully submitted that this petition for a writ of certiorari should be granted to review the decision and order of the Circuit Court of Appeals for the Second Circuit.

Irving L. Schanzer,
Counsel for Prudence Realization Corporation, Petitioner.

November, 1941.

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

IN THE MATTER OF THE PRUDENCE COMPANY, INC., Debtor. IN THE MATTER OF AMALGAMATED PROPERTIES, INC., Debtor. IN THE MATTER OF A PLAN OF REORGANIZATION OF AMALGAMATED PROPERTIES, INC., Debtor, in respect of the ZO-GALE FIRST MORTGAGE PARTICIPATION CERTIFICATES. PRUDENCE REALIZATION CORPORATION, Petitioner, A. JOSEPH GEIST, Trustee, Respondent.	In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act. Nos. 27196 and 27028.

REPLY BRIEF OF PETITIONER IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

IRVING L. SCHANZER,
Counsel for Prudence Realization Corporation, Petitioner.

CASES CITED

TEXTS

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

IN THE MATTER OF THE PRUDENCE COMPANY, INC., Debtor. IN THE MATTER OF AMALGAMATED PROPERTIES, INC., Debtor. IN THE MATTER OF A PLAN OF REORGANIZATION OF AMALGAMATED PROPERTIES, INC., Debtor, in respect of the ZO-GALE FIRST MORTGAGE PARTICIPATION CERTIFICATES. PRUDENCE REALIZATION CORPORATION, Petitioner, A. JOSEPH GEIST, Trustee, Respondent.	In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act. Nos. 27496 and 27028.

REPLY BRIEF OF PETITIONER IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

In his answering brief, respondent urges that the petition be denied because the certificates held by petitioner constitute a subordinate interest in the mortgage, (a) by the terms of the certificates themselves, and (b) by virtue of the default committed by petitioner's predecessor, the guarantor (Respondent's Brief, p. 6).

In reply petitioner respectfully submits that respondent's characterization of petitioner's participation as "a subordinate interest in the mortgage" is erroneous under decisions of the same court as that upon whose decisions respondent and the majority of the Court below relied in reaching the conclusion in this case.

In *In the Matter of the New York Title and Mortgage Company* (381-383 Park Avenue), 163 Misc. 318, aff'd without opinion 254 N. Y. App. Div. 722, the New York court held that the certificates held by Superintendent of Insurance as statutory liquidator of the guarantor were subordinate in time of payment to certificates held by others, but his interest was neither a junior interest in the mortgage nor a second mortgage. The court therefore refused to permit the trustee of the reorganized certificate issue to wipe out the Superintendent's interest in the mortgage in a foreclosure proceeding. That decision was predicated upon a determination that under the New York decisions, even though the guarantor's interest in the *proceeds* of the certificated mortgage was subordinate in time of payment to that of other holders, the interest of the guarantor in the mortgage itself was coordinate in lien with the interest of such holders. The "lien" cases cited by respondent under Point II of his brief therefore are inapplicable.

Although respondent refers to the certificate itself to show a clear agreement for subordination, an examination of the certificate shows no language indicating a priority right in favor of other holders as against Prudence. Moreover, the certification, printed on the certificate, made by the depositary, specifically states " * * * that the interest of the holder of this cerificate in said bond and mortgage is not subordinate to any other shares thereof and is not subject to any prior interest therein" (R. 15). Respondent further urges that the failure of Prudence to reserve to itself the right to hold certificates automatically requires subordination. However, there was no necessity for an express reservation of the right in Prudence to hold cer-

tificates. It did not issue the securities nor was it a trustee or depositary. Prudence was in fact the first holder of the certificates, having paid the full face value for the certificates, and sold them, not as an issuer but as such holder for value, to persons desiring to acquire a portion of its interest in the mortgage. No greater reason exists for requiring a reservation in favor of Prudence's retention or reacquisition of certificates than for a similar requirement in the case of subsequent purchasers who sold part or all of their holdings and later reacquired a portion of the sold certificates.

In relying upon the fact of the default by Prudence on its guaranty to substantiate the asserted right to priority in favor of other certificate holders, respondent ignores the further and controlling fact of the bankruptcy of the guarantor. The theory upon which respondent proceeded in the district court, and upon which he entered his order upon that court's determination, was not that the mortgage debt must be satisfied, but that no payments are to be made to petitioner until the *guaranty obligation* of the bankrupt guarantor to other Zo-Gale certificate holders has been fully paid (R. 50). Enforcement of the guaranty obligation in the forum in which the certificated mortgage was reorganized rather than in that of the guarantor's bankruptcy, and without regard for the rights of other creditors of the bankrupt guarantor, results in unauthorized preferences and is inconsistent with the policy and purpose of the Bankruptcy Act.

The "special equities" which respondent urges in favor of the Zo-Gale certificate holders as against other Prudence creditors are based solely upon the assertion of such equities by the New York Court of Appeals in cases arising in that court, but not involving a guarantor whose estate was being reorganized under the Bankruptcy Act. The debtor-creditor relationship existing between the Zo-Gale certificate holders and Prudence, upon which respondent relies to establish such "special equities" in favor of the Zo-Gale

certificate holders, is no different than the legal position of the other guaranty creditors of Prudence. The equities in fact lie with such other creditors as opposed to the special Zo-Gale group, as has been aptly illustrated in 51 Yale Law Journal 315, where in discussing the instant case the writer states at page 321:

> "Several elements of the immediate situation favor according equality of participation to the certificates held by the guaranteeing company. It is only the circumstance of that company's choice to invest in one of its own issues, rather than to distribute the entire issue to the public, which leads to its subordination in the principal case. Furthermore, the public holders of other issues of mortgage participation certificates and miscellaneous other creditors, in making their investment, relied upon the assets of the guaranteeing company, a part of which consisted of retained or reacquired shares. From the point of view of these other general creditors of the guarantor, the participating certificates held by the company would be considered substituted value for general assets expended in their acquisition, a consideration rejected by the decision in the instant case."

All published comments concerning the Circuit Court of Appeals decision in the instant case reject the majority's conclusion that the state court decisions are controlling upon the federal court in this case under *Erie R. Co.* v. *Tompkins,* 304 U. S. 64, 58 S. Ct. 817, 82 L. Ed. 1188. See 51 Yale Law Journal 315, 319; 55 Harvard L. Rev. 283, 284. Moreover, such comments concur in Judge Frank's conclusion that the New York decisions establish a rule of insolvency distribution. 51 Yale Law Journal 315, 320; 55 Harvard L. Rev. 283, 284. The majority conceded that such a rule would not be binding upon the federal courts.

The erroneous extension of the rule of *Erie R. Co.* v. *Tompkins, supra,* to the instant case by the Circuit Court of Appeals has created a precedent which jeopardizes the uniformity of administration of the Bankruptcy Act, and permits the several states by judicial determination or

statutory enactment to control the enforcement of the Bankruptcy Act. That extension is unauthorized by the decision of this Court in *Erie R. Co.* v. *Tompkins, supra,* and should be reviewed.

Wherefore, your petitioner prays that its petition for a writ of certiorari should be granted to review the order and decision of the Circuit Court of Appeals for the Second Circuit in this case.

Respectfully submitted,

IRVING L. SCHANZER,
Counsel for Prudence Realization
Corporation, Petitioner.

December, 1941.

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

PRUDENCE REALIZATION CORPORATION,
Petitioner,

against

A. JOSEPH GEIST, Trustee.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF ON BEHALF OF PETITIONER, PRUDENCE REALIZATION CORPORATION

IRVING L. SCHANZER,
Attorney for Prudence Realization Corporation, Petitioner.

TABLE OF CONTENTS

CASES CITED

STATUTES CITED

TEXTS CITED

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

PRUDENCE REALIZATION CORPORATION,
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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF ON BEHALF OF PETITIONER, PRUDENCE REALIZATION CORPORATION

Opinions Below

Written opinions have been rendered by the District Court (R. 123-125, not yet reported) and by the Circuit Court of Appeals for the Second Circuit, reported at 122 F. (2d) 503 (R. 129-145).

Jurisdiction

The decree of the Circuit Court of Appeals was entered on August 29, 1941 (R. 146). The petition for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit was granted by this Court on January 5, 1942. The jurisdiction of this Court is invoked under Section 240a of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A., Sec. 347-a).

Questions Presented

Must the guaranteed mortgage certificates held by petitioner (a creditors corporation formed to liquidate the assets of the guarantor pursuant to a reorganization under the Bankruptcy Act) be subordinated as to time of payment to certificates held by others? The majority of the Circuit Court of Appeals held the decisions of the New York Court of Appeals controlling on the issues presented on this appeal and accordingly answered in the affirmative. The Court also held that, despite the fact that preferences unauthorized by the Bankruptcy Act would result, the New York rule of distribution should be applied here so that creditors of all insolvent New York mortgage guarantee companies should receive similar treatment without regard to the tribunal in which the proceeding for the liquidation of any such guarantor took place.

The principal questions involved are:

(1) Was the Circuit Court of Appeals, under the decision of this Court in *Erie R. Co.* v. *Tompkins,* 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188, obliged to follow the decisions of the New York Court of Appeals even though the adoption of the rule of distribution established by such decisions results in restricting the equitable power of the bankruptcy court to classify claims of creditors of the guarantor for purposes of distribution under the Bankruptcy Act?

(2) Did the Circuit Court of Appeals, in following the state court decisions, improperly impose a restriction upon the equitable and statutory powers of the bankruptcy court to classify creditors' claims?

(3) Did the Circuit Court of Appeals properly impose upon the remaining unsecured creditors of an insolvent guarantor the burden of showing that the granting of priority to other unsecured creditors of the same insolvent would be inequitable?

(4) Was the Circuit Court of Appeals justified in granting preferential rights to certain creditors of the insolvent guarantor, after the confirmation of a creditors' plan of reorganization for the guarantor-debtor under Section 77B of the National Bankruptcy Act, where such plan did not provide for such preference and where such creditors were not separately classified?

Statement

Prudence Realization Corporation, petitioner here, is a creditors corporation organized as a result of the reorganization of The Prudence Company, Inc., under Section 77B of the Bankruptcy Act (R. 8, 9). The Prudence Company, Inc., hereafter called "Prudence", was organized under the Banking Law of the State of New York in 1919. It was engaged in the business of making loans secured by mortgages on real estate. The bonds and mortgages received for such loans were assigned to an affiliated corporation, Prudence-Bonds Corporation, the stock of which was owned by New York Investors, Inc., which also owned all of the common stock of Prudence (R. 16). Prudence-Bonds Corporation transferred these bonds and mortgages to corporate trust companies, called depositaries, and issued certificates of participation in such mortgages to Prudence, which in turn sold them to the general public together with its guaranty of payment of principal and interest (R. 16, 17). These mortgage participation certificates constituted the holders thereof tenants in common of the underlying mortgage and bond secured thereby. *In re Westover* (C. C. A. 2d), 82 F. (2nd) 177.

In the course of its business, from time to time Prudence either repurchased some of these certificates from the investing public, or received them in exchange for certificates in other mortgages. The certificates on hand, either prior to sale to the public or upon reacquisition, were included in the corporate assets of Prudence as evidenced by pub-

lished financial statements and corporate balance sheets prepared by certified public accountants (R. 18). It was the intention of Prudence in each instance, upon the acquisition of the aforementioned certificates, to hold them as investments, and not in cancellation or payment of its guarantee obligation (R. 18).

The Zo-Gale Certificate Issue, involved in this appeal, was created in the manner above described. The mortgage, originally in the principal amount of $480,000, was reduced by payment by the mortgagor to $390,000. Certificates to the extent of $382,800 are now outstanding. Included in the assets of the insolvent Prudence estate transferred to petitioner are $816.67 in principal amount of Zo-Gale certificates which were repurchased by Prudence in 1932 for full value (R. 17, 18). The remaining $7,200 interest in the mortgage, against which no certificates were issued, is now also held by petitioner, and was acquired by the Prudence Trustees from the Prudence-Bonds Corporation Trustees, subject, however, to the claims of general creditors of Prudence-Bonds Corporation (R. 20, 21).

In January, 1935, an involuntary petition for the reorganization of Prudence under Section 77B of the Bankruptcy Act was filed in the Eastern District Court and on February 1, 1935, the petition, consolidated with the debtor's voluntary petition for reorganization, was approved and trustees appointed. An order was entered in that proceeding prescribing the procedure for the filing of proofs of claim by creditors, including certificate holders of the Zo-Gale Issue, who were unsecured creditors of the debtor by reason of its guaranty of the Zo-Gale certificates (R. 19). In these proofs of claim, all certificate holders asserted unsecured claims for the full principal and interest due on the Prudence guaranty of the certificates held by them (R. 30-32), and they were allowed as such.

Prudence Realization Corporation, the petitioner here, was organized pursuant to a plan of reorganization for Prudence under Section 77B of the Bankruptcy Act (R. 8, 9). The plan was proposed by Reconstruction Finance

Corporation, the largest single creditor of Prudence, after a finding had been made that Prudence was insolvent. The plan provides that the stockholders of Prudence have no interest in the liquidation of its assets, and provides for the distribution of the proceeds of such liquidation to creditors only (R. 73). Petitioner is therefore solely a creditors' realization corporation and in no way represents interests of the old stockholders.

On March 16, 1936, pursuant to authorization secured in the Prudence proceeding, the petition for reorganization of Amalgamated Properties, Inc., as a subsidiary of Prudence, was approved by the Eastern District Court (R. 21). Included among its assets was the real property upon which the Zo-Gale Certificate Issue mortgage was a lien. The property had been purchased by Amalgamated on February 1, 1933, subject to the outstanding certificated mortgage (R. 21). In the Amalgamated proceeding a plan of reorganization for the Zo-Gale Certificate Issue was proposed which provided for the transfer of the real property by Amalgamated to a Trustee, appointed for Zo-Gale certificate holders, who also pursuant to said plan acquired the certificated mortgage. The lien of the mortgage was preserved for the benefit of all such certificate holders, who also became co-owners of the real estate. That plan of reorganization for the Zo-Gale Issue, as amended, was finally approved by the District Court on February 19, 1938, and the property, together with the entire outstanding mortgage, was transferred to A. Joseph Geist, Trustee, respondent herein (R. 5, 7, 8).

The order confirming the Zo-Gale plan, entered in that proceeding, provides that the rights of the certificates owned by Prudence to parity with those held by the other certificate holders is reserved for future judicial determination (R. 6). This provision also related to the uncertificated interest or share for which the Trustee by such order was directed to deliver a certificate to the Trustees of Prudence-Bonds Corporation (R. 7).

Throughout the proceedings above described, from February 1, 1935, Prudence was in reorganization and in 1938 a creditors' plan of reorganization for Prudence was proposed by Reconstruction Finance Corporation, its most substantial creditor. Copies of that plan of reorganization were forwarded to every holder of a guaranty claim as well as to other creditors of Prudence. Included among the guaranty claimants were the certificate holders in the Zo-Gale Issue. Throughout the period of consideration of the plan of reorganization, no claim was ever asserted in the Prudence proceeding on behalf of any Zo-Gale certificate holders to priority in distribution, nor was any claim made in that proceeding that by reason of the default by Prudence on its guaranty of the Zo-Gale certificate, the certificates held by Prudence in this issue were to be deemed subordinate to those held by other certificate holders (R. 20). *The order confirming the plan determines that there are no claims having priority except tax claims and claims for administration expenses* (R. 107). The plan of reorganization for Prudence was approved by the District Court on May 26, 1939, *fifteen months after the Zo-Gale plan was confirmed by the same judge* (R. 22).

In accordance with the provisions of the plan for Prudence, by assignment dated June 1, 1939, all of the assets of Prudence and its Trustees were transferred and assigned over to petitioner for the purpose of liquidation and distribution of the proceeds to Prudence creditors. Included in those assets were the certificates and uncertificated interest in the Zo-Gale Certificate Issue (R. 9). As is set forth in the order confirming the Prudence Plan, there are outstanding obligations of Prudence aggregating $134,123,-298.95 (R. 102). Of these claims only the claim of the United States of America for $400,000 has been fully paid.

Prior to the institution of the proceedings for the reorganization of Prudence, and in 1932, all of the stock of Amalgamated Properties, Inc., had been deposited as part of the collateral for a loan made by Reconstruction Finance Corporation to Prudence. In 1938, in accordance with a

decision of the ~~Circuit~~ Court of Appeals for the Second Circuit (*In re The Prudence Company, Inc.*, [C. C. A. 2d] 90 F. [2d] 587), the control and complete ownership of that subsidiary of Prudence passed to Reconstruction Finance Corporation.

Prudence-Bonds Corporation was found insolvent in March, 1937, and the plan of reorganization confirmed transferred all of its assets to a new corporation for the benefit of its secured creditors. *In re Prudence-Bonds Corporation,* (C. C. A. 2d) 122 F. (2d) 258, 261.

The instant proceeding was instituted in the Zo-Gale reorganization proceeding by A. Joseph Geist, as trustee of the reorganized Zo-Gale mortgage and underlying real property. The relief sought is an order determining that the certificates and uncertificated share, now held by petitioner, the creditors' realization corporation, are subordinate to those held by others and that no payments of either principal or interest shall be made on such certificates or share until the other certificate holders receive in full the principal and interest which had been guaranteed by Prudence (R. 9).

Petitioner, as representative of all of the Prudence creditors, urged that the issue presented should be determined solely in accordance with the Bankruptcy Act, and that under that Act the granting of the relief sought would result in an unauthorized preference in favor of Zo-Gale guaranty creditors as against the remaining creditors of Prudence, the insolvent guarantor (R. 24-26). The District Court, however, deemed the decisions of the New York Court of Appeals on the parity question controlling, and without considering the merits of the controversy, granted the application in all respects. The order entered upon such decision determines, first, that the certificates and share in this issue held by Prudence Realization Corporation for the benefit of all of the Prudence creditors are subordinate to those of the other certificate holders, and second, that no payment shall be made upon such certificates or share to Prudence Realization Corporation

"until the third party certificate holders have been paid in full the principal and interest guaranteed under the certificates held by such third party certificate holders" (R. 126).

The United States Circuit Court of Appeals for the Second Circuit on August 11, 1941, handed down its opinion affirming the decision of the District Court. The affirmance was by a divided court, the majority opinion being written by Circuit Judge Charles E. Clark and concurred in by Circuit Judge Thomas W. Swan and the dissenting opinion being written by Circuit Judge Jerome N. Frank (R. 57-73).

The majority believed the decisions of the New York Court of Appeals on the question of parity to be controlling under the decision of this Court in *Erie R. Co.* v. *Tompkins,* 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188, 114 A. L. R. 1487.

Although the question arises as a controversy in the Zo-Gale reorganization proceeding as to the payment of the proceeds of the mortgage, in substance the issue relates to the distribution of the assets of the bankrupt guarantor (pp. 13 ff. and 28 ff., *infra*).

Specification of Errors

The court below erred,

(1) in holding that the decisions of the New York court determining questions of distribution of an insolvent mortgage guaranty company's assets under state statutes are binding upon the bankruptcy court under the authority of *Erie R. Co.* v. *Tompkins,* 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188;

(2) in failing to hold that, in accordance with the provisions of the Bankruptcy Act, Prudence Realization Corporation is entitled to share equally with other certificate holders in the proceeds of the Zo-Gale Mortgage Certificate Issue;

(3) in holding that the certificates of participation in the Zo-Gale Certificate Issue owned by Prudence

Realization Corporation are not entitled to parity of distribution with other certificates held by the general public, but are subordinate to the certificates held by others;

(4) in holding that Prudence Realization Corporation as owner of the uncertificated interest acquired from Prudence-Bonds Corporation in the Zo-Gale mortgage is not entitled to parity of distribution with the other holders of certificates, but is subordinate to such other holders;

(5) in failing to hold that, by the failure of the other holders of Zo-Gale certificates to file claims for priority in the Prudence proceeding or require provision for priority in their favor in the plan of reorganization for Prudence, such holders have waived their rights and may participate only as general creditors without priority or preference as against any other creditors of Prudence.

Summary of Argument

POINT I—The decision of this Court in Erie R. Co. v. Tompkins does not require the federal bankruptcy court to follow state court decisions establishing rules of insolvency distribution (p. 10).

POINT II—Where rules of insolvency distribution prescribed by the Bankruptcy Act and state decisions are in conflict, the Bankruptcy Act is paramount and must be applied by the bankruptcy court (p. 21).

POINT III—Upon equitable grounds petitioner's certificates are entitled to parity of distribution (p. 24).

POINT IV—The plan of reorganization for the insolvent guarantor did not separately classify Zo-Gale guaranty creditors and bars respondent's claim for priority (p. 27).

POINT V—The uncertificated interest in the mortgage held by petitioner is entitled to parity (p. 31).

POINT VI—The decision of the Circuit Court of Appeals for the Second Circuit is erroneous in all respects and should be reversed (p. 34).

POINT I

The decision of this Court in *Erie R. Co.* v. *Tompkins* does not require the federal bankruptcy court to follow state court decisions establishing rules of insolvency distribution.

The Zo-Gale certificate owners as holders of guaranty claims are included in the interests represented by petitioner, and they participate in the proceeds of the liquidation of the assets of the Prudence estate on a parity with all other creditors. The main issue on this appeal, therefore, is whether the Zo-Gale certificate holders, in addition to sharing pro rata with other unsecured Prudence guaranty creditors in the other assets of the insolvent estate, are entitled to a priority claim against such portion of the assets as are represented by Zo-Gale certificates held in the name of petitioner. If parity is accorded petitioner's participating interests in the Zo-Gale issue, the Zo-Gale certificate holders will receive only their pro rata share of the proceeds of the certificates. However, if the decision of the Circuit Court stands, they will receive the entire proceeds of the certificates, and remaining guaranty creditors will be barred from any interest in such asset until the full amount of principal and interest guaranteed by Prudence has been received by the Zo-Gale certificate holders.

Independently of consideration of the merits of the controversy between the parties to this appeal, the majority of the Circuit Court of Appeals believed itself bound to follow the decisions of the New York courts on the parity question because of this Court's decision in *Erie R. Co.* v. *Tompkins*,

304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188. As a basis for reaching that conclusion, the majority found that the rule established by the New York decisions rested upon the interpretation of the contract of guaranty and the certificates as constituting an agreement that the certificates repurchased by the guarantor were to be subordinate in time of payment to the certificates held by others. The Court recognized, however, that if the local decisions established a rule of insolvency distribution, the federal court in administering a bankrupt estate was free to apply its own rules of distribution, and *Erie R. Co.* v. *Tompkins, supra,* did not apply.

It is submitted that the decision in *Erie R. Co.* v. *Tompkins, supra,* establishes no more than that, in cases arising in the federal court by reason of diversity of citizenship between the parties to the litigation, the federal court may not apply its own general law but is required to apply the local law (1941) 51 Yale L. J. 315, 319; (1941) 55 Harv. L. Rev. 283, 284. The clarification made by that decision in the rule established in *Swift* v. *Tyson,* 16 Pet. 1, 10 L. Ed. 865, was to affirm the fact that there is no federal general common law, and that "except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the state" and that "whether the law of the state shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern." *Erie R. Co.* v. *Tompkins,* 304 U. S. at p. 78, 58 S. Ct. at p. 822.

There can be no implication from the opinion in that case that any abdication of clearly defined federal prerogative was intended. In *City of New York* v. *Feiring,* 313 U. S. 283, 61 S. Ct. 1028, 85 L. Ed. 1313, decided after *Erie R. Co.* v. *Tompkins, supra,* in determining whether the New York City Sales Tax was a tax within the meaning of §64 of the Bankruptcy Act, this Court said, 313 U. S. at p. 285, 61 S. Ct. at p. 1029:

> "Whether the present obligation is a 'tax' entitled to priority within the meaning of the statute is a federal

> question. *New Jersey* v. *Anderson,* 203 U. S. 483, 491, 27 S. Ct. 137, 139, 51 L. Ed. 284; cf. *Burnet* v. *Harmel,* 287 U. S. 103, 110, 53 S. Ct. 74, 77, 77 L. Ed. 199; *Palmer* v. *Bender,* 287 U. S. 551, 555, 53 S. Ct. 225, 226, 77 L. Ed. 489; cf. *United States* v. *Pelzer,* 312 U. S. 399, 61 S. Ct. 659, 85 L. Ed. , decided March 3, 1941. Intended to be nationwide in its application, nothing in the language of §64 or its legislative history suggests that its incidence is to be controlled or varied by the particular characterization by local law of the state's demand. Hence we look to the terms and purposes of the Bankruptcy Act as establishing the criteria upon the basis of which the priority is to be allowed."

Similarly the courts of the State of New York have recognized the fact that the Bankruptcy Act and its construction by the federal courts control the state courts in determining questions arising under the Act. In *Brenen* v. *Dahlstrom Metallic Door Company,* 189 App. Div. 685, 178 N. Y. S. 846, the court said, 189 App. Div. at p. 688, 178 N. Y. S. at p. 848:

> "The Bankruptcy Act having been passed by Congress pursuant to the power delegated to it by the Federal Constitution (Art. 1, §8, subd. 4) is the supreme law of the land. Its provisions are paramount to any State statute, and we have always recognized and followed the decisions of the Federal Court construing it dealing with questions arising under that Act, even if they are in conflict with our own decisions. (Cf. *Hyde Park Flint Bottle Co.* v. *Miller,* 179 App. Div. 73; *Manheim* v. *Loewe,* 185 id. 601, 607.)"

[illegible] case, the New York decisions deemed controlling by the majority of the Circuit Court, were rendered in cases involving the liquidation of guaranteed mortgage companies in statutory proceedings (New York Insurance Law, Art. XVI), and the reorganization of the guaranteed securities pursuant to specific statutory authorization. ("Schackno Act," New York L. 1933, ch. 745; "Mortgage Commission Act", New York L. 1935, ch. 19.) In no instance was the guarantor a corporation whose assets were being or had been administered by the federal court under the Bankruptcy Act.

The New York decisions determine that, in cases arising under the state statutes above referred to, where certificates of participation have been repurchased by the guarantor, in the absence of very clear and unambiguous language showing a contrary intent, the court will not permit the guarantor to share in the proceeds of insufficient security until the holders of its guaranties shall have been paid in full. Where no evidence of intention appears, the courts imply an intention that the guarantor's holdings shall be subordinated. *In re Union Guarantee & Mortgage Co.*, 285 N. Y. 337, 34 N. E. (2d) 345; *Pink v. Thomas*, 282 N. Y. 10, 24 N. E. (2d) 724; *In re Title & Mortgage Guaranty Co. of Sullivan County*, 275 N. Y. 347, 9 N. E. (2d) 957, 115 A. L. R. 35; *Title Guarantee and Trust Company v. Mortgage Commission*, 273 N. Y. 415, 7 N. E. (2d) 841.

In the instant case, the certificate itself contains no language showing an intention to subordinate certificates held or repurchased by the guarantor. On the contrary, the certification made by the depositary, printed on the certificate, specifically states, "* * * that the interest of the holder in said bond and mortgage is not subordinate to any other shares thereof and is not subject to any prior interest therein" (R. 11). The sole basis upon which subordination could be found here would be that since Prudence guaranteed the securities, the debtor-creditor relationship existing between the company and the certificate holders creates a "special equity" which justifies a preference in favor of these certificate holders as against the remaining creditors of the insolvent guarantor. *In re Title & Mortgage Guaranty Company of Sullivan County, supra.*

If the rule adopted by the New York Court were applied solely in a case where the guarantor was itself solvent, there could be no reasonable objection to its determination. Avoidance of circuity of action could properly be a basis for such a rule. However, upon the insolvency of the guarantor and the coming into existence of rights on the part of its creditors to share in its assets, avoidance of circuity

of action no longer represents a tenable ground for a determination that certificates which it has repurchased and which constitute a part of the assets of its estate shall be subordinated in time of payment to the claims of certain certificate holders who are also included in the class of general creditors of the bankrupt guarantor.

The distinction existing between the case arising where the guarantor is solvent and where it is insolvent was carefully analyzed in *Kelly v. Middlesex Title Guarantee and Trust Company*, 115 N. J. Eq. 592, 171 Atl. 823 (Chancery), affirmed on this opinion by the New Jersey Court of Errors and Appeals in 116 N. J. Eq. 574, 174 Atl. 706. There, in holding that the participation certificates held by the insolvent guarantor were entitled to parity with other certificate holders, the court said, 115 N. J. Eq. at pp. 599, 600, 171 Atl. at p. 827:

> "The argument—and the conclusion by many authorities—that where the mortgagee gives to his assignee his guarantee of payment he should not be allowed to share *pro rata* in the proceeds of the security to the detriment of his assignee, has its sole logical basis (in the absence of any provision, agreement or representation between the parties in that behalf) in the theory of avoidance of circuity of action. As holders of the security they stand on an equal footing; each is entitled to his share of the proceeds of the security. If the assignee's share is not sufficient to pay him in full, the assignor is bound by his guaranty to pay him the deficiency. Giving the assignee a preferred interest in the proceeds in such a case simply enforces the performance of the guaranty; it saves the assignee the delay, trouble and cost of a separate suit to enforce the guaranty and marks no inequity to the guarantor or anyone else—*if* there is no other person having an interest in the security.
>
> "In the instant case, however, there *are* other persons having an interest in the security—to wit, the general creditors of the insolvent assignor, represented by the commissioner as trustee. The issue is not between the assignees (participation certificate holders) and the assignor (Middlesex Company or its stockholders). It is between the assignees on the one side

and the general creditors on the other. It is solely between successive assignees—for the trustee for the general creditors stands not in the position of the assignor, but in the position of an assignee of the unsold portion of the mortgage. The rights and interests of *all* general creditors in this unsold portion of the mortgage (and in all the other assets of the Middlesex Company) are equal (proportionately to their claims). The claim of the assignees on the guaranty is a general, unsecured claim. To grant to them any greater right or interest in the bond and mortgage than that which was specifically assigned to them as security would be giving them security for an unsecured claim, and would be giving them, as such unsecured creditors, an unlawful and inequitable preference over the other unsecured creditors."

The New York Court of Appeals has rejected avoidance of circuity of action as the basis for its rule, recognizing the fact that such a basis is inadequate to justify preferential treatment to a certain few creditors where the guarantor is insolvent. Although nominally describing its rule as being one based on "the intention of the parties, either as actually expressed, or as derived from the natural equity of the situation" (*Matter of Title and Mortgage Guaranty Company, supra,* 275 N. Y. at pp. 354, 355, 9 N. E. (2d) at p. 960), the clearest statement of the actual basis appears in *Pink v. Thomas, supra,* 282 N. Y. at pp. 12, 13, 24 N. E. (2d) at p. 725:

"* * * but if a mortgage company guarantees payment of certificates which it sells to third parties it is not entitled to share in the proceeds received from the sale of collateral until the third-party certificate holders are paid in full unless the certificates sold clearly provide that it retains such right (*Matter of Title & Mortgage Guaranty Company of Sullivan County,* 275 N. Y. 347), the underlying principle being that a mortgage company which sells participating certificates in a mortgage and itself guarantees them is in the position of a debtor, *and the equitable rule existing between debtors and creditors applies.* On default and absence of sufficient funds to pay certificate holders other than

itself in full it cannot share in the assets available until the certificate holders are paid in full. That is the law, and it is right. Having guaranteed the payment of the certificates it would be *highly inequitable* to permit it to step in and divert part of the security available to pay such certificate holders whom it had expressly guaranteed should be paid. No one in this case questions that principle.

"It should take very clear and unambiguous language in the certificates to overcome that rule and substitute a holding that in spite of its guarantee of payment it should be permitted to share in the available assets even though the certificates which it had guaranteed should be paid remain unpaid. *Such an inequitable result could be accomplished if the language used was so clear and unmistakable that the courts would be compelled to give effect to the intent of the parties as expressed in the writing. Otherwise the equitable rule should prevail.*" (Italics supplied.)

No portion of the language quoted above deals with intention of the parties as requiring subordination. The rule established speaks in terms of distribution between two creditors of an insolvent, one of whom holds claims against the other relating to the debt due from the insolvent. In determining their respective rights to share in the inadequate proceeds of the insolvent estate, the court has held that in its view the debtor-creditor relationship existing between the two creditors creates a special equity which requires that the guaranty creditor's participation be preferred until the guaranty claim is fully paid. That preference in favor of the guaranty creditor is justified by the court as an equitable rule of distribution to be applied under circumstances where the inadequate primary security is security not alone for the primary obligation but for the guaranty as well. (1941) 51 Yale L. J. 315, 317, 318; (1941) 51 Harv. L. Rev. 283, 284.

In discussing the basis of the New York rule, Judge Frank, dissenting below, said, 122 F. (2d) at page 509:

"Reference is also made to 'the implied or actual intent of the parties'; *Pink* v. *Thomas*, 282 N. Y. 10,

15, 24 N. E. 2d 724, 726; *Granger* v. *Crouch,* 86 N. Y. 494; 'implied' is significantly differentiated from 'actual' intent and thus means intent 'implied in law', i. e., not intent at all. And the same is true of the locution in some of the above cases as to a 'presumption of intent' as distinguished from the 'actual intent'."

Referring to the above quoted passage from *Pink* v. *Thomas,* which describes the New York rule as an "equitable rule", Judge Frank said further, 122 F. (2d) at page 509:

> "That is not the verbiage which the New York court would employ if it were determining that the parties had an actual intention, expressed in their contract, to create a preference; but it is verbiage appropriate in spelling out a rule of insolvency administration. And my brother judges concede that *Erie R. Co.* v. *Tompkins* does not require us to adopt such a rule."

Such a determination of equitable considerations, however, must be considered in the light of state insolvency statutes, which provide that whether or not the mortgage or underlying property constitute part of the assets of the insolvent guarantor, the certificate holder is deemed a secured creditor and may file a claim only for the difference between its guaranty obligation and the value of the mortgage. (New York Insurance Law, §544, subd. 6.) *Matter of New York and Mortgage Company,* 277 N. Y. 66, 13 N. E. [2d] 41). In reaching its conclusion that such holders were secured creditors under the state statute, the New York court contrasted the wording of the state statute with the provisions of the Bankruptcy Act, recognizing the contrary rule under the latter statute as stated by this Court in *Ivanhoe Bldg. & Loan Ass'n* v. *Orr,* 295 U. S. 243, 55 S. Ct. 685, 79 L. Ed. 419. Thus in *Matter of New York Title and Mortgage Company,* 160 Misc. 67, 289 N. Y. S. 771, reversed on other grounds, 277 N. Y. 66, 13 N. E. (2d) 41, *supra,* the court, in defining the phrase "Secured Creditor" under the New York statute, said (160 Misc. at p. 79, 289 N. Y. S. at p. 785):

"The definition of 'secured creditor' found in the Bankruptcy Act has not been carried over into the Insurance Law of this State."

Whatever equity may exist in cases arising under the New York insolvency statutes, where upon subordination, the certificate holder's claim on the guaranty is reduced not alone by the value of his participating interest in the mortgage but by the value of the guarantor's interest as well, such equity disappears in the bankruptcy court. In the latter court, under the *Ivanhoe* case, *supra,* there is no deduction from the claim, whether the guarantor's interest is deemed on a parity with, or subordinate to, the other participants. The effect of subordination under the New York insolvency laws increases the remaining guaranty creditors' participation in a partially diminished estate, whereas in bankruptcy, such subordination results in the diminution of the estate without any variation in the claims against it. The partial compensation granted to other creditors under the New York law for the preference granted the particular certificate holders, finds no counterpart under the Bankruptcy Act. Adoption, by the bankruptcy court, of the state rule of distribution results in the preference in favor of the single group of creditors, adding to the security for their claims and diminishing the estate, but leaves their participation in the remaining assets of the insolvent guarantor unaffected.

To establish such a rule of distribution as being based upon "special" or "natural" equities is to neglect entirely the rights of other guaranty creditors, holding similar guaranty claims, and constitutes a grant of a special status to a few solely by reason of the fortuitous acquisition by the guarantor of certificates in the issue in which such few are interested. Had the cash or other assets used by the guarantor to purchase these certificates remained in the general estate, such creditors would be entitled only to their pro rata share. Where such assets were exchanged for certificates, "Whatever value they [the certificates] have should be regarded as a substitute for such of the general

assets as was used to purchase them" (*Matter of New York Title & Mortgage Co.*, 253 App. Div. 308, 310, aff'd 278 N. Y. 488, 15 N. E. [2d] 430), and no greater benefits should be conferred upon the particular creditors solely by reason of such substitution.

Nothing decided by this Court in *Erie R. Co.* v. *Tompkins, supra,* requires the federal bankruptcy court to adopt the New York rule directing the preferential treatment to be accorded to particular unsecured creditors. If the determination by the New York courts constitutes a rule of administration of insolvent estates, it may not properly be transformed into a rule of interpretation merely because it is stated in such terms by the state court and therefore become binding on the federal court. In *Jennings, Receiver* v. *United States Fidelity & Guarantee Co.*, 294 U. S. 216, 55 S. Ct. 394, 79 L. Ed. 869, 99 A. L. R. 1248, Mr. Justice Cardozo in reading a state statute which created a trust in favor of certain groups of creditors upon the insolvency of a bank, said (294 U. S. at p. 226):

> "A trust so created, to arise upon insolvency, is a preference under another name. As applied to a national bank, the preference is plainly inconsistent with the system of equal distribution established by the federal law. R. A. §5236; 12 U. S. C. §194; *Davis* v. *Elmira Savings Bank*, 161 U. S. 275, 283, 284; *Easton* v. *Iowa*, 188 U. S. 220, 229; *Cook County National Bank* v. *United States*, 107 U. S. 245; *Lewis* v. *Fidelity & Deposit Co. of Maryland, supra* (292 U. S. 449). The power of the nation within the field of its legitimate exercise overrides in case of conflict the power of the states."

The legality of a preference arising through state judicial construction is determined not by the local law creating it but by provisions of the federal statute under which it is being enforced. The issue is one for federal determination and is "not influenced by consideration of local law." *Yonkers* v. *Downey, receiver*, 309 U. S. 590, 597, 60 S. Ct. 796, 84 L. Ed. 964.

So, too, where under Illinois decisions an assignment of future wages was held to create a lien which survived a bankruptcy discharge, this Court rejected the state decisions as being "destructive of the purpose and spirit of the bankruptcy act" and enjoined the prosecution of an Illinois state court action to enforce such a lien after the wage earner's discharge in bankruptcy. *Local Loan Co.* v. *Hunt*, 292 U. S. 234, 54 S. Ct. 695, 78 L. Ed. 1230.

The majority of the court below recognized the requirement of the Bankruptcy Act for pro rata distribution and the applicable law was stated by Judge Clark in his opinion at 122 F. (2d) at page 505, where he said:

> "If, however, the matter is one of insolvent liquidation only, we have a different situation. It is a necessary implication of the requirement of a plan of reorganization that 'it is fair and equitable and does not discriminate unfairly in favor of any class of creditors,' Bankruptcy Act, former §77B(f)1, as it is a corollary of the strict priorities rule of *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 60 S. Ct. 1, that a plan may not discriminate between different members of the same class of creditors or classify creditors arbitrarily, without due regard to their economic status as defined in their respective claims. See *Southern Pacific Co.* v. *Bogert*, 250 U. S. 483, 492, 39 S. Ct. 533, 63 L. Ed. 1099; 49 Yale L. J. 881, 882; 2 Gerdes, Corporate Reorganizations, 1682; Finletter, Bankruptcy Reorganization, 465. Similarly, Bankruptcy Act, §65a, requires, in liquidation, the distribution of 'dividends of an equal per centum' 'on all allowed claims, except such as have priority or are secured.' *Moore* v. *Bay*, 284 U. S. 4, 52 S. Ct. 3, 76 L. Ed. 133, 76 A. L. R. 1198; *Globe Bank & Trust Co.* v. *Martin*, 236 U. S. 288, 305, 35 S. Ct. 377, 59 L. Ed. 583; *Sampsell* v. *Imperial Paper & Color Corp.*, 61 S. Ct. 904, 907. The only departures made from the ordinary rule of equality are based on some very definite equity, such as fraud, *Pepper* v. *Litton*, 308 U. S. 295, 60 S. Ct. 238, 84 L. Ed. 281, mismanagement of the debtor by a parent corporation, *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307, 59 S. Ct. 543, 83 L. Ed. 669, or concealment of a claim to the prejudice of another creditor,

In re Bowman Hardware & Electric Co., 7 Cir., 67 F. 2d 792. "In the absence of such an equity, subordination is not a function of the bankruptcy court. *Crowder* v. *Allen-West Commission Co.*, 8 Cir., 213 F. 177, 184; *Sampsell* v. *Imperial Paper & Color Corp.*, *supra; cf. Moise* v. *Scheibel*, 8 Cir., 245 F. 546."

The respondent here has rested upon proof of the guaranty and default upon its obligations and the New York decisions, as his sole foundation for the claim to priority (R. 3-9). The fact of insolvency of the guarantor, and the rights of other creditors of the bankrupt, the protection of which is the proper function of the bankruptcy court, have not been considered either by respondent or the majority of the Circuit Court of Appeals. The bankruptcy court may not relieve the priority claimant of the burden of showing his right to such priority or preference. *Sampsell* v. *Imperial Paper & Color Corporation*, 313 U. S. 215, 61 S. Ct. 904, 85 L. Ed. 1293. The determination that such priority right exists may not rest upon decisions of the local courts but should be determined in accordance with applicable bankruptcy provisions. *In re Blue Bird Appliance Co.*, (C. C. A. 8th) 292 Fed. 127; *Rapple* v. *Dutton*, (C. C. A. 9th) 226 Fed. 430; *John Deere Plow Co.* v. *McDavid*, (C. C. A. 8th) 137 Fed. 802.

POINT II

Where rules of insolvency distribution prescribed by the Bankruptcy Act and state decisions are in conflict, the Bankruptcy Act is paramount and must be applied by the bankruptcy court.

The majority of the Circuit Court of Appeals believed that even if the bankruptcy court is not bound to follow the rule established by the New York decisions, the rule should be applied, since, "Creditors of different New York mortgage-guaranty companies ought to receive similar treatment, without regard to the tribunal in which liquida-

tion occurs, for certainly their investments were made under substantially identical conditions". 122 F. (2d) at p. 507.

No justification is given by the Court for the adoption of this doctrine in the instant case. Certainly no peculiar factors are present here which are absent in any other normal business transactions. It has never been held by this Court or any other federal court that in any other type of debtor-creditor relationship, the federal bankruptcy court may follow state decisions determining distributive rights under state insolvency law, when such decisions conflict with the provisions of the Bankruptcy Act, and that any principle of uniformity requires such a result.

On the contrary, it has been held that where any conflict exists, the Bankruptcy Act is paramount, and state insolvency laws are suspended. *Sturges v. Crowninshield,* 4 Wheat. 122, 4 L. Ed. 529; *International Shoe Co. v. Pinkus,* 278 U. S. 261, 49 S. Ct. 108, 73 L. Ed. 318. A congressional statute which directed the federal bankruptcy courts to apply state rules of insolvency distribution where a conflict with the Bankruptcy Act existed would violate the Constitutional direction to "establish * * * uniform Laws on the subject of Bankruptcies throughout the United States." (Constitution, Art. I, §8.) For the federal court to disregard general bankruptcy precedents in a particular case simply because the state court has previously passed upon the effect of its own insolvency laws on the specific transaction, does no less violation to the constitutional mandate for uniformity.

In (1941) 51 Yale L. J. 315, 321, the author, discussing the instant case said:

> "As pointed out in Judge Frank's dissent, uniformity of bankruptcy administration throughout the United States is, by express constitutional provision, made paramount to federal conformity with the rule of a particular state. This constitutional mandate would seem to preclude a federal court from following state insolvency law in order to promote local uniformity, especially where the bankruptcy rule is directly contrary, as in the instant case."

It is submitted that in the instant case, the majority's conclusion is based upon a failure to appreciate the statutory nature of the state court proceedings, and the varying provisions for the administration of insolvents' estates under the state insolvency and the national bankruptcy laws. No cogent reason appears why the federal court should assume the desirability of uniformity with state rules of distribution in cases where the claims in the state and federal insolvency proceedings are filed on directly opposed theories. As has been demonstrated *supra*, under Point I, the New York Insurance Law, §544, subd. 6, as construed by the New York court in *Matter of New York Title and Mortgage Company*, 160 Misc. 67, 289 N. Y. S. 771, *supra*, directs the filing of guaranty claims as secured claims, even though the security for the debt is not the property of the insolvent. The *Ivanhoe* case, *supra*, establishes, as the bankruptcy rule, that a creditor holding the same type of claim files as an unsecured creditor in a bankruptcy proceeding. The conclusion of the majority of the Circuit Court that the distributive rights of such creditors shall remain identical in the state insolvency and the federal bankruptcy proceedings, disregards the basic distinction existing in the Bankruptcy Act between the participation accorded to secured and unsecured creditors. As secured creditors of the bankrupt guarantor, they would be required to deduct the value of the security from their guaranty claim, [Bankruptcy Act, §57h (11 U. S. C. A., §93h)], and to that extent their participation in the insolvent estate would be diminished, for the benefit of the remaining general creditors. In the absence of the requirement that their claims be reduced under the Bankruptcy Act, the guaranty holders participate in the insolvent's estate on a parity with other claimants for the full amount of their claims.

Under the circumstances, to fully carry out the majority's decision that similar treatment should be accorded to guaranty creditors whether the insolvent is liquidated under the New York Insurance Law or the Bankruptcy Act, requires more than the result in the instant case. To adequately

carry out that decision, the Bankruptcy Act definition of "secured creditor" must be abandoned in favor of the state definition found in the New York Insurance Law. Failing that, the desire for uniformity expressed by the majority becomes meaningless and inadequate as the basis of decision. If "similar treatment" is to be accorded the guaranty creditor, the rights of other creditors must be considered. Recognition of such rights requires that the guaranty creditor's claims must be established in bankruptcy on the same basis as they are allowed in the New York insolvency proceedings. That, the bankruptcy court may not do in view of the specific terms of the Bankruptcy Act. *Ivanhoe Bldg. & Loan Assn.* v. *Orr, supra.*

In discussing the majority's conclusion as to the desirability of uniformity, Judge Frank, dissenting below, said, 122 F. (2d) at p. 510:

> "Related considerations are pertinent with respect to the suggestion in the majority opinion that, even if we are free to ignore the New York rule, we should not do so, since, thereby, persons in similar circumstances, *vis a vis* an insolvent guarantor, will be treated differently by state and federal tribunals. Such an argument is self-defeating: No doubt uniformity between state and federal courts is desirable; but so is nationwide uniformity of bankruptcy administration; if the majority opinion assists in establishing the first of these, it helps to destroy the second. Where a paramount public policy does not demand it, I can see no reason for our going out of our way to transplant, from the state to the federal courts, a doctrine which is so curiously lacking in logic and fairness as the New York rule of automatic subordination."

POINT III

Upon equitable grounds petitioner's certificates are entitled to parity of distribution.

In deciding that equitable considerations required a determination that petitioner's certificates are to be sub-

ordinate in time of payment to certificates held by others, the majority of the Circuit Court of Appeals erroneously assumed that there was here involved a consideration of mutual claims between inter-related companies which therefore justified the conclusion that their customers should receive prior payment, and further erroneously concluded that petitioner took with full notice of the situation from the reorganization proceedings generally in view of the explicit reservation of the question and the confirmation of the reorganization of the Zo-Gale certificate issue (R. 136) (122 F. [2d] at 507).

The original relationship between Prudence (the guarantor), Prudence-Bonds Corporation (the mortgagee) and Amalgamated Properties, Inc. (the debtor), to which the majority referred, has been extinguished. Prudence and Prudence-Bonds Corporation, judicially found to be insolvent, have been reorganized separately for the sole benefit of their respective creditors (R. 44, 97); *In re Prudence-Bonds Corporation,* (C. C. A. 2d) 122 F. (2d) 258, 261. The creditors of Prudence-Bonds Corporation who are now its sole owners are also creditors of Prudence (R. 100, 101). Amalgamated Properties, Inc. is now owned by Reconstruction Finance Corporation, also a Prudence creditor, which accepted the Amalgamated stock as part of the security for a loan to Prudence before the date of the acquisition by Prudence of the Zo-Gale certificates here in question. *In re The Prudence Company, Inc.,* (C. C. A. 2d) 90 F. (2d) 587.

The issue here therefore remains one solely between creditors of Prudence and not between inter-related corporate entities. The rights of creditors have intervened and to use the majority's own words, "as a matter of practical equity" *all* of such creditors should receive similar treatment without priority or preference in favor of one as against the others. Although the rule established by the New York court and adopted by the majority of the Circuit Court of Appeals may properly be applied where the guarantor is solvent, *"it becomes a totally different rule*

when, as here, the guarantor itself is a bankrupt; then the problem which confronts the federal courts is one of equitable distribution, under the Bankruptcy Act of the insufficient proceeds of a guaranteed obligation among all the guarantor's creditors, including the assignees of a portion of the guaranteed obligation." (Judge Frank's opinion, 122 F. [2d] at p. 508.)

The assumption that respondent representing all of the Prudence creditors took with full notice of the situation because of the reservation in the Zo-Gale reorganization proceeding fails to recognize the status of petitioner as such creditors' representative. The adoption of the corporate entity, Prudence Realization Corporation, in order to permit the liquidation of the bankrupt's assets for the benefit of all creditors was an expedient which did not alter the existing rights of the individual creditors by whom petitioner's assets are owned. As Judge Frank said in his dissenting opinion in referring to the effect of the reservation of the Zo-Gale proceedings:

> "that sort of notice is inefficacious to create equities, although it would preserve them if they already existed; Appellant represents the interests of Prudence's creditors; it was created long after they became creditors; they became creditors without any such notice; the notice to which the majority refers served merely to keep open for future decision the question, first raised in the Zo-Gale proceedings, of whether or not, because of facts previously occurring (including no such notice), there should be a subordination." (122 F. [2d] p. 508.)

There appear to be no equitable considerations present in the instant case which compel the abandonment of the bankruptcy rule that "equality is equity". On the contrary:

> "Several elements of the immediate situation favor according equality of participation to the certificates held by the guaranteeing company. It is only the circumstance of that company's choice to invest in one of its own issues, rather than to distribute the entire issue to the public, which leads to its subordination in

the principal case. Furthermore, the public holders of other issues of mortgage participation certificates and miscellaneous other creditors, in making their investment, relied upon the assets of the guaranteeing company, a part of which consisted of retained or reacquired shares. From the point of view of these other general creditors of the guarantor, the participating certificates held by the company would be considered substituted value for general assets expended in their acquisition, a consideration rejected by the decision in the instant case." (1941) 51 Yale L. J. 315, 321, discussing the instant case.

POINT IV

The plan of reorganization for the insolvent guarantor did not separately classify Zo-Gale guaranty creditors and bars respondent's claim for priority.

The order entered in the District Court upon the granting of respondent's motion in the instant case provides that petitioner shall not be entitled to receive any distribution of principal or interest until "the third party certificate holders have been paid the full principal and interest guaranteed under the certificates held by such third party certificate holders" (R. 126).

The asserted right to priority in payment in favor of other certificate holders therefore is based upon, and measured by, the *guaranty* obligation rather than the amount of principal and interest due on the *mortgage,* and constitutes another method of enforcing collection of the guaranty obligation. *Kelly* v. *Middlesex Title Guarantee and Trust Company, supra.* Such judicially granted right to enforcement of collection is not predicated upon a determination that the other certificate holders have a prior lien in the mortgage as against the guarantor or its successor, the creditors of Prudence Realization Corporation. On the contrary, it has been held by the New York State court that no such priority of *lien* exists. *In the Matter of the*

New York Title and Mortgage Company (*381-383 Park Avenue*), 163 Misc. 318, 296 N. Y. S. 644, aff'd without opinion 254 N. Y. App. Div. 722, 4 N. Y. S. (2d) 1004. There, in refusing to permit the trustee of the certificated mortgage to wipe out the liquidator's certificated interest in the mortgage represented by subordinated certificates, the court held that the trustee of the mortgage was a trustee for *all* certificate holders, and though the guarantor's interest in the proceeds of the certificated mortgage was subordinate in time of payment to that of other holders, the interest of the guarantor in the mortgage itself was coordinate in lien and could not be cut off by foreclosure.

In the instant case, Prudence was reorganized under Section 77B of the Bankruptcy Act and all claims based upon its guaranties were filed in the proceeding for its reorganization (R. 19). Included were claims filed by or on behalf of the Zo-Gale certificate holders (R. 19). All such claims were filed as unsecured claims, no reservation being made in the proof of claim with respect to any security or claim for security with respect to the guaranty obligation. The claims were allowed in the full amount of principal and interest at the guaranteed rate (R. 101). In accordance with the provisions of Section 77B, the plan of reorganization adjusted the participating interest of all creditors in the Prudence estate. Such adjustment constitutes a discharge of any obligations on the guaranty in the future except as provided by the plan. *City Bank Farmers Trust Co.* v. *Irving Trust Company*, 299 U. S. 433, 57 S. Ct. 292, 81 L. Ed. 324; *Black* v. *Richfield Oil Corporation*, (D. C. S. D. Cal.) 41 F. Supp. 988.

Paragraph 19 of the order confirming the Prudence plan of reorganization provides that the claims of guaranty holders "shall be payable without interest only as provided in Article IV of the Amended Plan and only to the extent that the New Company's assets shall be sufficient to pay them * * *." The same paragraph provides that there are no claims or interests against the estate having priority except claims for amounts due as taxes to the United States

of America, the State of New York and reorganization expenses (R. 106, 107). The plan itself does not separately classify the Zo-Gale certificate holders but deems them included within the general category of guaranty creditors (R. 70, 71). Paragraph 24 of the same order of confirmation provides that the provisions of the plan and of the order of confirmation shall be binding upon all creditors secured or unsecured (R. 110).

It is submitted from the foregoing that the Prudence plan adjusted all claims against the insolvent guarantor, and constitutes a final determination of the rights of any of the creditors to participate in the assets of that corporation which were turned over to petitioner pursuant to the plan. The failure of the Zo-Gale certificate holders to secure any special rights in these assets or any part of them in that plan constitutes a bar to any further attempts to make additional recoveries upon the guaranty obligation. The Zo-Gale reorganization proceeding could not effectively grant any additional rights to the Zo-Gale certificate holders with respect to the guaranty obligation. The proper forum for adjustment with respect to that obligation was The Prudence Company, Inc. reorganization proceeding. *In re Diversey Building Corp.*, (C. C. A. 7th) 86 F. (2d) 456; *In re Nine North Church Street, Inc.*, (C. C. A. 2d) 82 F. (2d) 186.

Recognizing the fact that the Zo-Gale certificate holders in asserting their right to priority as against petitioner in the distribution of the proceeds of the Zo-Gale mortgage are not asserting a lien claim, no justification appears for the additional distributions to be directed to be made to them on account of the guaranty obligation. If parity of participation is accorded petitioner, the proceeds of the participation certificates held by petitioner in the Zo-Gale mortgage will become part of the general Prudence estate and will be distributed pro rata among all of its creditors including the Zo-Gale guaranty creditors. However, a determination that petitioner's participation in the Zo-Gale mortgage is subordinate to that of the Zo-Gale holders

grants to that special group of creditors a right to divert such assets from the general Prudence estate for their sole benefit and permits them further to participate without change in status in the distribution of the remaining assets of the estate. The respective rights of the various guaranty claimants to share in the Prudence assets have been determined in the Prudence plan, and the order confirming the plan is *res adjudicata* with respect to any later effort to enforce additional rights. *In re Lyman Richey Sand & Gravel Co.*, (D. C., D. Neb.) 42 F. Supp. 158, 160, 161. That final adjudication may not be collaterally attacked. *Stoll* v. *Gottlieb*, 305 U. S. 165, 59 S. Ct. 134, 83 L. Ed. 104.

It is a necessary corollary of the rule requiring the division of creditors into classes according to the economic status of their claims that such classification must take place in the bankruptcy or insolvency forum. *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 60 S. Ct. 1, 84 L. Ed. 110; *Northern Pacific Railway* v. *Boyd*, 228 U. S. 482, 33 S. Ct. 554, 57 L. Ed. 931; (1941) 51 Yale L. J. 315, 320, 321. Without the requirement that all factors necessary for the consideration of the issue of classification be submitted for determination in that forum, the basis of the rule becomes unsound. If the creditor may reserve additional rights against particular assets of the bankrupt despite his failure to urge such rights in the bankruptcy court, the latter's determination of classification rests upon an inadequate basis to the prejudice of other creditors.

In the Prudence bankruptcy proceeding, the Zo-Gale certificate holders proved their claims as unsecured creditors, were so classified and under the Prudence plan are to receive parity of treatment with all other unsecured creditors. No preferential treatment in their favor was provided in the plan and no claim for any preference was asserted in the Prudence proceeding by the Zo-Gale creditors. The bankruptcy court's determination that their claim should receive equal treatment with other guaranty claims as having the same economic status was supported

by the similarity in the various guaranty obligations and the absence of any characteristics which distinguished the Zo-Gale claims from any other guaranteed claims. Had the additional right to priority with respect to the proceeds of a portion of the assets of the insolvent Prudence estate been asserted in the Prudence proceeding and been upheld by the court, the remaining creditors would have been entitled to separate classification with the attendant right to reject a plan which recognized the priority claim of the Zo-Gale creditors but failed to take such priority into account in providing for pro rata distribution of the remaining assets among all creditors, including the Zo-Gale certificate holders. In effect, the Zo-Gale certificate holders, after confirmation of the Prudence plan, are seeking to file a further claim against the assets of the insolvent guarantor's estate which would require a modification of that plan. That the bankruptcy court will not permit in the Prudence proceeding (*In re Diana Shoe Corp.* [C. C. A. 2d], 80 F. [2d] 92), nor may such modification be effected in the *Zo-Gale* proceeding, as is here being attempted. *In re Lyman Richey Sand & Gravel Co., supra; cf. Stoll* v. *Gottlieb, supra.*

POINT V

The uncertificated interest in the mortgage held by petitioner is entitled to parity.

Even if the Circuit Court were correct in applying the New York decisions to the instant case, it should have held that the uncertificated share in the Zo-Gale mortgage now held by petitioner was entitled to parity. However, the court deemed the uncertificated portion of the Zo-Gale mortgage now held by petitioner as having the same status as the actually issued certificates of participation, and therefore held them to be subordinate to the outstanding certificates. The court assumed that since Prudence-Bonds Corporation did not give any money value for the Zo-Gale

bond and mortgage when it received the original assignment from Prudence, all portions of the mortgage which were not certificated and not sold were actually the property of Prudence at all times, and therefore determined the question of parity without regard for the distinction existing between the certificated and the uncertificated portions of the mortgage (122 F. [2d] at p. 507).

The court overlooked the circumstances under which the Prudence Trustees acquired the uncertificated portion of the mortgage from the Trustees of Prudence-Bonds Corporation. To dispose of certain claims of the Prudence estate against Prudence-Bonds Corporation, a compromise was entered into with the trustees of Prudence-Bonds Corporation. As part of the consideration for such compromise, the uncertificated portion of the Zo-Gale mortgage as well as similar interests in other certificate issues were transferred to the Prudence Trustees, *subject, however, to general claims of general creditors of Prudence-Bonds Corporation* (R. 20). The requirement that these portions of the mortgages be acquired subject to the rights of general creditors of Prudence-Bonds Corporation recognizes their status as corporate assets of Prudence-Bonds Corporation and the fact of its insolvency. It is to be noted that Prudence-Bonds Corporation had outstanding approximately $56,000,000 of personal obligations based upon its issuance of bonds upon which it was primary obligor (R. 38).

Upon the insolvency of Prudence-Bonds Corporation, the rights of these creditors to any of its corporate assets became clear and determined. The assignment of the Zo-Gale mortgage by Prudence to Prudence-Bonds Corporation, absolute by its terms, containing no defeasance provisions, might properly be considered as part of the Prudence-Bonds estate by these bondholders, and constitutes an estoppel against the possible Prudence claim of ownership. *In re The Prudence Company, Inc.*, (C. C. A. 2d) 82 F. (2d) 755, cert. den. 298 U. S. 685, 56 S. Ct. 957, 80 L. Ed. 1405.

Respondent in asserting in the District Court and the Circuit Court of Appeals that the uncertificated portion should be treated on the same basis as the actually issued certificates held by petitioner did so in recognition of the fact that even under the decisions of the New York courts such uncertificated portion in the hands of Prudence-Bonds Corporation would be entitled to parity of treatment with the other holders of certificates. *Pink* v. *Thomas; Matter of Title Mortgage Guaranty Co.; Title Guaranty and Trust Co.* v. *Mortgage Commission,* all *supra.* Under these decisions, Prudence-Bonds Corporation, bearing no debtor-creditor relationship to the other holders of certificates, would be entitled to parity.

The precise issue presented in this case with respect to the uncertificated portion of the mortgage has been decided by the New York court in *Matter of Southeast Corner of National Boulevard and West Broadway, Long Beach (Bond and Mortgage Guarantee Company; Guaranty No. 170794)*, Supreme Court, Kings County, reported in the New York Law Journal January 31, 1940. There a trustee of a certificated mortgage guaranteed by the Bond and Mortgage Guarantee Company then in liquidation made a motion for an order adjudicating the certificates held by the Liquidator of the Guarantee Company to be subordinate to other certificates in the series. Mr. Justice Brower determined that the certificates acquired by the Superintendent of Insurance of the State of New York as Rehabilitator from Title Guarantee and Trust Company, which had issued and sold the certificates guaranteed by Bond and Mortgage Guarantee Company as part of a business transaction, were entitled to parity with all other certificates in the series. In making this determination Mr. Justice Brower said:

> "This share or interest when held by Title Guarantee & Trust Company was on a parity with and equal to the shares represented by certificates held by other holders (Title Guarantee and Trust Co. v. Mortgage Commission, 273 N. Y. 415). It was not acquired in

partial performance of the contract of guaranty. It was never the property of the Guarantee Company prior to the entry of the order of rehabilitation. The question of parity should be determined, therefore, as of the time this interest was owned by Title Guarantee and Trust Company (cf. Matter of Lawyers Mortgage Co. (6801 Bay Parkway), 15 N. Y. Supp. 2nd, 239). It was then on a parity and it now still is on a parity."

The decision above referred to and quoted has direct application to the question here in issue. The Superintendent of Insurance held a position identical to that of the Prudence Trustees. The transaction by which the uncertificated interest was acquired by the Prudence Trustees, as was true in the State Court decision, took place after the institution of the reorganization proceeding. Prudence-Bonds Corporation, like Title Guarantee and Trust Company, had merely issued the certificates but had not guaranteed payment of principal or interest, nor had it become the primary obligor. All portions of the decision above quoted refer specifically to the state of facts present in the instant case, since the transaction by which Prudence acquired this interest in the mortgage was simply one of the many steps in the reorganization of Prudence. The position, therefore, taken by Prudence Realization Corporation that the acquisition of the uncertificated interest in the mortgage resulted in a purchase by the Prudence Trustees of the rights of Prudence-Bonds Corporation which would be entitled to parity is borne out in all detail by the applicable decisions of the State Court.

POINT VI

The decision of the Circuit Court of Appeals for the Second Circuit is erroneous in all respects and should be reversed.

Respectfully submitted,

Irving L. Schanzer,
Attorney for Prudence Realization Corporation, Petitioner.

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

PRUDENCE REALIZATION CORPORATION,
Petitioner,

vs.

A. JOSEPH GEIST, Trustee.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF ON BEHALF OF PRUDENCE REALIZATION CORPORATION, PETITIONER

IRVING L. SCHANZER,
Attorney for Prudence Realization Corporation, Petitioner.

CASES CITED

TEXTS

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF ON BEHALF OF PRUDENCE REALIZATION CORPORATION, PETITIONER

I

The decisions relied upon by respondent do not support the contention that the New York rule on the parity question is one of contract construction, binding upon a federal court in a bankruptcy proceeding under *Erie R. Co.* v. *Tompkins,* 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 188. On the contrary, an analysis of the decision in *Pink* v. *Thomas,* 282 N. Y. 10, 24 N. E. (2d) 724, principally relied on, demonstrates that the rule is merely an equitable rule for the distribution of insolvent estates in New York and as such is not binding on the bankruptcy courts. *Pink* v. *Thomas, supra,* shows clearly that the New York rule does not depend for its application upon the intention of the parties as expressed in the agreement, but is an "equitable" rule applied where the agreement itself is

actually silent as to intention and even where there is no other evidence whatsoever to show actual intent of the parties. Moreover, the court there also stated that it would reach the conclusion that the guarantor's certificates were subordinate unless the language of the agreement was so clear and unmistakable that the courts would be "compelled" to give effect to the intent of the parties as expressed in the writing. On that basis it is inconceivable that by its reference to the debtor-creditor relationship created by the extraneous guaranty agreement the court may be deemed to have "construed" the certificate.

A more reasonable analysis of the New York rule and one which will coincide with the rationale of the decision in *Pink* v. *Thomas, supra,* is that the court assumes a "special equity" to exist in favor of certificate holders other than the guarantor because of the debtor-creditor relationship existing solely by virtue of the guaranty obligation, and that such "special equity" requires the granting of priority in distribution of the proceeds of the insufficient security.

Described by the New York court as "an equitable rule" (*Pink* v. *Thomas, supra,* 282 N. Y. at pp. 12, 13, 24 N. E. [2d] at p. 725), the New York courts do not consider that they are required to construe the specific language of the certificate as constituting an agreement that the guarantor's certificates are subordinate. The language of the certificates is referred to in the New York cases solely to negative, if possible, a determination that the intent of the parties was to provide for parity of distribution. The New York courts, having established a so-called "equitable" rule of distribution, look to the agreement solely to determine whether it contains

> "very clear and unambiguous language * * * to overcome that rule and substitute a holding that in spite of its guarantee of payment it should be permitted to share in the available assets even though the certificates which it had guaranteed should be paid, remained unpaid. Such an inequitable result could be

accomplished if the language used was so clear and unmistakable that the courts would be compelled to give effect to the intent of the parties as expressed in the writing. Otherwise the equitable rule should prevail" (*Pink v. Thomas, supra*, 282 N. Y. at p. 13, 24 N. E. [2d] at p. 725).

The rule, so stated, constitutes a rule of distribution rather than one of contract construction. (1941) 51 Yale L. J. 315, 317, 318; (1941) 51 Harv. L. Rev. 283, 284.

Respondent also apparently concludes that the debtor-creditor relationship arising solely from the making of the agreement of guaranty estops petitioner from obtaining parity. The only authorities cited by respondent in support of that conclusion are the New York decisions which refer to the debtor-creditor relationship as establishing a "special equity" justifying the application of an "equitable" rule of distribution. None of the opinions quoted by respondent speaks in terms of estoppel nor has respondent by reference to any other facts demonstrated the application of that theory to the instant case.

As above indicated, the debtor-creditor relationship is utilized by the New York courts solely to permit it to apply a rule of distribution which prefers the holder of the guaranteed certificate as against the guarantor's remaining creditors. But such debtor-creditor relationship existing between the Zo-Gale certificate holders and Prudence was no different than that existing between Prudence nd the holders of certificates in other issues which were also guaranteed by Prudence. Upon the reorganization of Prudence and the transfer of its assets to petitioner for the purpose of liquidation solely for the benefit of all of its creditors, the so-called "special equity", upon which the New York courts have relied, disappears and their rights by reason of the guaranty are now measured by their rights against The Prudence Company, Inc., as compared with the rights of all of the other Prudence creditors. The equities require that all holders of Prudence guaranties receive equal treatment. This can only

be accomplished by refusing priority to the publicly-held certificates. Thus, no basis whatsoever for any estoppel has been shown.

II

Respondent in Point II of his brief merely reasserts his position that the decision of this Court in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188, requires the bankruptcy court to follow the New York decisions on the parity question. In referring to the opinion in that case as authority for his position, respondent fails to recognize the fact that the Bankruptcy Act is an Act of Congress. The portion of the opinion quoted by respondent at page 24 of his brief reads:

> "*Except in matters governed by the Federal Constitution or by Acts of Congress,* the law to be applied is the law of the State."

No effort has been made to refute the authority of *City of New York* v. *Feiring*, 313 U. S. 283, 61 S. Ct. 1028, 85 L. Ed. 1313, nor of *Local Loan Co.* v. *Hunt*, 292 U. S. 234, 54 S. Ct. 695, 78 L. Ed. 1230, cited at pages 11 and 20, respectively, of petitioner's main brief. These two cases illustrate clearly that the administration of the Bankruptcy Act is controlled by the provisions of that statute and the decisions of the federal courts, not by the local law.

Citation of *Lerner Stores Corporation* v. *Electric Maid Bake Shops* (C. C. A., 5), 24 F. (2d) 780; *In re Knox-Powell-Stockton Co.* (C. C. A., 9), 100 F. (2d) 979; and *General Motors Acceptance Corporation* v. *Caller* (C. C. A., 6), 106 F. (2d) 584, at page 27 of respondent's brief, adds nothing to his argument in the instant case. These cases do no more than establish that the state law is controlling on the validity and extent of *liens*. However, no lien question is presented here. Although respondent rejects petitioner's assertion that the New York court has held that the right of priority granted to certificate holders other than the guarantor is a priority in payment and not a

priority in the mortgage lien, respondent's quotation from petitioner's cited authority, *In the Matter of the New York Title & Mortgage Company,* 163 Misc. 318, 296 N. Y. S. 644, affirmed without opinion, 254 App. Div. 722, 4 N. Y. S. (2d) 1004, appearing at pages 23, 24 of respondent's brief, conclusively demonstrates the validity of petitioner's conclusion. There the court held that although subordinate in payment, the guarantor's interest could not be considered the equivalent of a second mortgage, and therefore could not be cut off by foreclosure.

Moreover, by reference to the lien cases, and his consideration of the rights of other Prudence creditors as involving an "alien question", respondent has demonstrated his failure to appreciate the question here in issue.

Petitioner, in asserting its right to parity here for the benefit of all Prudence creditors, is not relying solely on the fact of the bankruptcy reorganization of the Zo-Gale certificate issue as making inapplicable the New York decisions. Petitioner, in its main brief, has illustrated that respondent's claim to priority in the distribution of the proceeds of the Zo-Gale mortgage is founded upon and measured by the guaranty obligation; that its effect, if successful, is to provide respondent with a right to collect upon that guaranty obligation without having submitted that additional right to collection for adjudication in the Prudence proceeding in which the guaranty obligation was being reorganized. The arguments advanced by petitioner in Point IV of its main brief, and the authorities there cited, have neither been considered nor answered by respondent. Had petitioner's views been given consideration it would appear clear that even if the federal bankruptcy court were bound to follow state court interpretations of contracts or liens, the obligation remains the creditor's to assert such claims in the bankruptcy forum, in this instance in the Prudence proceeding, or to be bound by the provisions of a plan of reorganization which limited collections on the guaranty obligation. *Black* v. *Richfield Oil Corporation* (D. C. S. D. Cal.), 41 F. Supp. 988.

To illustrate, where a mortgagee, and therefore a secured claimant, files a claim in a bankruptcy proceeding as an unsecured creditor, even though the binding state law gives him the status of a secured creditor, the bankruptcy court will hold that he has waived his right to the security and may participate in the distribution of the bankrupt estate solely as an unsecured creditor. *In re O'Gara Coal Co.* (C. C. A., 7), 12 F. (2d) 426; *In re H. Herrmann Furniture Co.* (U. S. D. C., S. D. N. Y., 1937) (Coxe, D. J.), C. C. H. Dec., par. 4473. In such case the state court determination of the creditor's right to a lien position is immaterial, because the distributive rights of the bankrupt's creditors are established by their asserted claims against the bankrupt, and the creditor's failure to take the benefit of the state law in asserting his claims is deemed a waiver *under the Bankruptcy Act.*

Similarly, in the instant case, at no time did the Zo-Gale certificate holders as guaranty creditors assert special contract rights in the Prudence proceeding which would warrant their being awarded a special status in the distribution of the Prudence assets in payment or adjustment of the guaranty obligation. To that extent, the question as to whether the New York law is applicable becomes academic. Its applicability in any case would be conditioned upon the creditor's formal proof of claim or upon claims thereafter asserted in the course of the Prudence reorganization. Having accepted unequivocally the benefits of the Prudence plan, and having consented to its provisions limiting the enforcement of the original guaranty obligation, the Zo Gale creditors may not now in the Zo-Gale proceeding disregard such limitations and secure additional rights of collection at the expense of other Prudence guaranty creditors.

The Prudence plan provides for a transfer of all of the Prudence assets to petitioner for the benefit of the Prudence creditors. The plan also provides that the assets are received by petitioner subject only to the requirement that payments be made to creditors *in accordance with the plan.*

The guaranty claims, *qua* guaranty claims, are extinguished and are replaced by the obligation on the part of petitioner to distribute to holders of such claims the proceeds of the liquidation of the Prudence assets in accordance with the provisions of the Prudence plan. The original guaranty creditors of Prudence, therefore, are not guaranty creditors of petitioner, but have been converted into beneficiaries of a liquidating trust, with a right to share in the distribution of its proceeds in accordance with the provisions of the plan.

In view of the insolvency of Prudence, the plan of reorganization, proposed by Reconstruction Finance Corporation and accepted by the Prudence creditors, was an agreement, not between the creditors and the debtor, but between the creditors alone, that all of their claims, based upon the guaranty or other obligations of the debtor, were to be adjusted by the distribution of all of the insolvent's assets among the creditors in the manner and in accordance with the formula set forth in the plan. There was no provision for collections on the guaranty obligation in addition to those provided in the plan.

The certificates and the guaranty did not constitute one, inseparable obligation. The certificate represented an undivided interest in a mortgage constituting a lien on real estate and constituted its holder the owner of an aliquot portion of the mortgage debt, and no more. The guaranty was the separate obligation of Prudence that the principal and interest of the certificate would be paid, but did not enlarge or otherwise affect the certificate holder's interest in the mortgage. The guaranty obligation could be released or satisfied without affecting the mortgage lien. Had the guaranty obligation been discharged by an outright release, respondent's right to make further collection on the guaranty would be barred. *Stoll* v. *Gottlieb,* 305 U. S. 165, 59 S. Ct. 134, 83 L. Ed. 104. Where, as here, it has been extinguished by the acceptance of the *quid pro quo* provided for in the Prudence plan, additional collection upon the guaranty obligation is similarly barred.

On page 4 of respondent's brief he urges that the question of parity was reserved in the Prudence plan, and in support of that argument he quotes a portion of Article IV, paragraph 2(a) of the plan. Although in the manner quoted by respondent the plan seems to provide affirmatively that Prudence-held certificates are to be deemed to be subordinate to certificates held by others, that effect is achieved only by respondent's omission of the preliminary phrase which modifies the entire provision of the plan. As properly quoted, paragraph 2(a) appears in the plan as follows:

> "2. (a). *If in the judgment of the Board of Directors* no definitive proration should be made of the value of the Collateral or other security for a particular certificate issue, due to uncertainty whether certificates of such issue held in the Debtor's estate on the Effective Date are on a parity with other certificates of such issue, the deduction to be made pursuant to the foregoing clause (1) shall be based in the first instance on the assumption that the certificates so held in the Debtor's estate are not entitled to parity, and an appropriate reserve shall be established by the New Company to provide for the additional distribution to be made to certificate holders of such issue if the Board of Directors shall be later satisfied that such parity exists; the Board of Directors being authorized to discontinue such reserve if and when satisfied that such parity does not exist;" (R. 82). (Italics supplied.)

The italicized portion of the above quotation, which was omitted by respondent, demonstrates clearly that there was no intention to reserve the question nor to provide for a method of distribution by specific provision of the plan, but that the provision was inserted merely as an administrative guide to be applied and adopted if, solely in the judgment of the Board of Directors of the New Company, the question of parity remained open for consideration. Certainly if it was the intention of the parties to the Prudence plan that the question of parity remain unaffected by the fact of the Prudence reorganization for the benefit of its creditors, and the further fact that no priorities in

the distribution of the Prudence assets were ever claimed or asserted in the Prudence proceeding by the Zo-Gale certificate holders, definite provisions could have been written into the plan to assure that result.

No effort has been made by respondent to overcome the effect of the provisions of the order approving the Prudence plan, which provides that there shall be no priority except for the payment of the claims of the United States Government and the State of New York for taxes and administration expenses (R. 107).

Respondent's reference to the District Judge's determination that the question of parity was at all times reserved is of no assistance. The District Court in reaching its conclusion cited no provisions of either the Zo-Gale or Prudence plans or orders of confirmation which justified the arbitrary conclusion that the question had been reserved (R. 124). Nor did the majority of the Circuit Court of Appeals which affirmed the District Court place any reliance on the reservation clauses referred to by respondent, except to reach the conclusion that such reservation in the Zo-Gale order of confirmation placed the remaining Prudence creditors represented by petitioner on notice of the fact that the question of parity was reserved (122 F. [2d] at p. 507). The conclusion by the majority of the Circuit Court of Appeals that such reservation had the effect of constituting petitioner, as creditors' representative, a purchaser with notice was considered and rejected by Judge Frank dissenting below (122 F. [2d] at p. 508) and has been referred to in petitioner's main brief at page 26.

III

Respondent has attempted to confuse the issues presented in the instant case by asserting that arguments, made by petitioner to support its position that its uncertificated interest in the Zo-Gale mortgage is entitled to parity, have

also been urged by it to justify granting parity on the issued certificates which it holds (Respondent's Brief, p. 18). Petitioner has distinguished the two situations and has dealt separately with them in its main brief (Point V).

Again, at page 19 of his brief, respondent asserts that petitioner has argued that since Reconstruction Finance Corporation owns the stock of Amalgamated Properties, Inc., which it had previously accepted as security for a loan to Prudence, petitioner's certificates are entitled to parity. As is apparent from the clear language in petitioner's main brief, at page 25, reference to the Reconstruction Finance Corporation's ownership of Amalgamated Properties, Inc., was to refute the unsupported statement by the majority of the Circuit Court of Appeals that all that was involved here was a consideration of mutual claims of inter-related companies.

Respondent, however, misstating petitioner's position, asserts that the pledge does not result in the creation of a right to parity, citing *Matter of Lawyers Title & Guaranty Co.*, 287 N. Y. 264, as authority. Since petitioner has never relied on the pledge of the Amalgamated stock with Reconstruction Finance Corporation as the basis for its claim to parity, the cited authority does not refute petitioner's arguments. However, a reading of the opinion in that case demonstrates the extent to which the New York rule has carried the court. In that connection it is interesting to note that Chief Judge Lehman of the New York Court of Appeals, who either wrote or concurred in the prevailing opinions in prior cases holding the guarantor's certificates to be subordinate, dissented in the latest decision, without opinion.

Moreover, the decision in *Matter of Lawyers Title & Guaranty Co., supra,* serves to demonstrate the effect of the opinion of the majority of the Circuit Court of Appeals in the instant case that similar treatment should be accorded certificate holders without regard to the forum in which the liquidation occurs (122 F. [2d] at p. 507). If such similarity of treatment is made mandatory by an

affirmance in the instant case, the federal bankruptcy court administering the estate of a corporation which has issued the identical certificate with the same guaranty in the states of New York, Pennsylvania and New Jersey will be required to apply the local law and to decide distributive rights of creditors in the following manner: Where certificates have been repurchased by the guarantor and retained by it, those issued in New York and Pennsylvania must be subordinated (*Pink* v. *Thomas, supra; Agricultural Trust & Savings Company's Mortgage Pool* case, 329 Pa. 581, 198 Atl. 16) and those issued in New Jersey are entitled to parity (*Kelly* v. *Middlesex Title Guarantee and Trust Co.*, 115 N. J. Eq. 592, 171 Atl. 823 [Chancery], affirmed on this opinion by the New Jersey Court of Errors and Appeals in 116 N. J. Eq. 574, 174 Atl. 706): where such certificates have been pledged by the guarantor to a foreign corporation, those issued in New York are to be subordinated (*Matter of Lawyers Title & Guaranty Co., supra*) and those issued in Pennsylvania and New Jersey are entitled to parity (*Land Title Bank & Trust Co.* v. *Schenck*, 335 Pa. 419, 6 Atl. [2d] 878; *Kelly* v. *Middlesex Title Guarantee and Trust Co., supra*).

Under the circumstances outlined, it is submitted that where the similarity of treatment required by the decision of the majority of the Circuit Court of Appeals in the instant case is made mandatory upon the bankruptcy court the uniformity in bankruptcy legislation and administration required by the United States Constitution, Article I, Section 8, no longer can exist. Petitioner respectfully submits that the constitutional mandate for uniformity takes precedence over the views expressed by the majority in the instant case.

IV

There can be no doubt that any subordination in bankruptcy of claims having the same economic status as other claims is to be determined by the bankruptcy court upon

consideration of the merits of each particular case. In its main brief, petitioner has demonstrated that the decision of this Court in *Erie R. Co.* v. *Tompkins, supra,* does not require the federal bankruptcy court to apply state court decisions establishing rules of distribution in state insolvency proceedings and, as above indicated, there is nothing in respondent's brief showing the contrary. It is submitted that in the bankruptcy court, subordination of some of the claims of the same economic class will not be decreed unless compelling equities are present which justify such subordination. Respondent has wholly failed to show that such equities exist in his favor but, on the contrary, it appears that it would be inequitable under the circumstances in the instant case to permit the other holders of Zo-Gale certificates, after having proved their claims in the Prudence reorganization proceeding for the full face amount of the guaranty, to syphon away a portion of the Prudence assets by allowing priority in the Zo-Gale proceeding.

As has heretofore been demonstrated, Prudence was engaged in the business of making guaranties similar to the one involved in the instant case and at the time of its reorganization many thousands of such guaranties were outstanding. In addition, Prudence dealt in bonds and certificates of issues which it had guaranteed and it was only by fortuitous circumstances that upon the date of its petition in the bankruptcy proceeding Prudence held in its portfolio certificates of any particular issue rather than similar securities in other issues which it had guarantied. Such certificates were general assets upon which all holders of Prudence guaranties relied in making their investments and were considered part of the assets available for the payment of the guaranty obligation. Under such circumstances it would seem to be highly inequitable to permit the Zo-Gale certificate holders in effect to obtain a higher return upon the guaranties held by them than that received by the holders of other Prudence guaranties,

merely because at the time of its bankruptcy Prudence held some of the Zo-Gale certificates.

In its main brief, petitioner has referred to the fact that the guaranty creditors in state insolvency proceedings are deemed secured creditors, as contrasted with their status as unsecured creditors under the Bankruptcy Act; that under the state insolvency laws, where subordination of the guarantor's interest is determined by the New York court, the guaranty creditor is required to deduct the value of the guarantor's interest as well as the value of his own security from his claim against the remaining assets of the insolvent guarantor, and that under the Bankruptcy Act no equivalent credit is given to the insolvent estate in the event of a determination of subordination. Therefore, what might be considered an equitable result under the state insolvency statutes appears to be highly inequitable when applied to a case arising under the Bankruptcy Act.

V

Under all of the circumstances in the instant case petitioner respectfully submits that the decision of the Circuit Court of Appeals for the Second Circuit should be reversed.

Respectfully submitted,

IRVING L. SCHANZER,
Attorney for Prudence Realization Corporation, Petitioner.

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

IN THE MATTER OF THE PRUDENCE COMPANY, INC., Debtor. IN THE MATTER OF AMALGAMATED PROPERTIES, INC., Debtor. IN THE MATTER OF A PLAN OF REORGANIZATION OF AMALGAMATED PROPERTIES, INC., Debtor, in respect of the Zo-Gale First Mortgage Participation Certificates. PRUDENCE REALIZATION CORPORATION, Petitioner. A. JOSEPH GEIST, Trustee, Respondent.	In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act Nos. 27496 and 27028.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

A. JOSEPH GEIST,
Attorney for Respondent.

MORRIS A. MARKS,
GEORGE E. NETTER,

TABLE OF CONTENTS

TABLE OF CASES

STATUTES

TEXTS

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

IN THE MATTER OF THE PRUDENCE COMPANY, INC., Debtor. IN THE MATTER OF AMALGAMATED PROPERTIES, INC., Debtor. IN THE MATTER OF A PLAN OF REORGANIZATION OF AMALGAMATED PROPERTIES, INC., Debtor, in respect of the ZO-GALE FIRST MORTGAGE PARTICIPATION CERTIFICATES. PRUDENCE REALIZATION CORPORATION, Petitioner, A. JOSEPH GEIST, Trustee, Respondent.	In Consolidated Proceedings for Reorganization under Section 77B of the Bankruptcy Act. Nos. 27496 and 27028.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Statement of the Case

The Prudence Company, Inc., a banking corporation organized under the laws of the State of New York, loaned

Zo-Gale Realty Co., Inc., a sum of money secured by a bond and a first mortgage covering premises 202 Riverside Drive in the City of New York (R. 16).

The Prudence Company, Inc., assigned the bond and mortgage without consideration to a corporation known as Prudence-Bonds Corporation. The stock of both corporations was owned by a parent corporation, New York Investors, Inc. (R. 39).

Prudence-Bonds Corporation, under a plan described at length in *In re The Westover, Inc.,* (2 Cir.) 82 F. (2d) 177, and *In re Prudence Co., Inc.,* (2 Cir.) 89 F. (2d) 689; *In re Prudence Co., Inc.,* (2 Cir.) 98 F. (2d) 559, cert. den. 306 U. S. 636, 59 S. Ct. 485, 83 L. Ed. 1037; *In re Prudence Bonds Corp.,* (2 Cir.) 79 F. (2d) 212 (R. 20), deposited the bond and mortgage with a depositary, and thereafter, at the request of The Prudence Company, Inc., it issued participation certificates of undivided shares in specified amounts, delivered them to The Prudence Company, Inc., which affixed its guarantee to the certificates and sold them to the public and retained the proceeds (R. 38-39).

The relationship of guarantor and creditor was thus created between The Prudence Company, Inc., and the certificate holders. A. Joseph Geist, as trustee, holds the trust estate for the benefit of the certificate holders (R. 10-11). The certificates in the instant proceeding are known and referred to as the Zo-Gale Certificate Issue.

The participation certificates did not reserve to the guarantor, The Prudence Company, Inc., the right to hold or retain similar shares for its own account (R. 36-37).

The original obligor defaulted and, to avoid foreclosure proceedings, conveyed the premises securing the mortgage to Amalgamated Properties, Inc., a subsidiary corporation of The Prudence Company, Inc., which owned all its stock. The trustees of The Prudence Company, Inc., debtor, constituted the board of directors and were the officers of Amalgamated Properties, Inc. (R. 5).

The Prudence Company, Inc., defaulted under its guarantee and filed a petition for reorganization under Section 77B of the National Bankruptcy Act on February 1, 1935 (R. 5); on March 17, 1936, the petition of the subsidiary corporation, Amalgamated Properties, Inc., debtor, for reorganization under Section 77B of the National Bankruptcy Act was approved as duly filed in the proceedings of The Prudence Company, Inc., debtor (R. 5).

At the time of the filing of its petition for reorganization under Section 77B of the National Bankruptcy Act, The Prudence Company, Inc., debtor, owned $7,000 par amount of unissued Zo-Gale participation certificates (R. 8, 39) and $816 of repurchased and reacquired Zo-Gale participation certificates (R. 11, 40).

The plan for the reorganization of the Zo-Gale Certificate Issue "In the Matter of Amalgamated Properties, Inc., debtor," was confirmed by order of the United States District Court for the Eastern District of New York on February 19, 1938 (R. 7). This order reserved for future determination the question of the parity of the participation certificates owned by The Prudence Company, Inc., debtor (R. 8-9) in the proceedings of Amalgamated Properties, Inc., debtor, with those guaranteed by it and sold to the public. The order of consummation was entered on April 9, 1939 (R. 9). The fee to premises 202 Riverside Drive and to the bond and mortgage were transferred to A. Joseph Geist, trustee respondent, pursuant to the order of confirmation "In the Matter of Amalgamated Properties, Inc., debtor" (R. 10-11).

The narrow issue which the petitioner presents for consideration is:

Shall the assets of Amalgamated Properties, Inc., debtor, in the Zo-Gale Certificate Issue be distributed ratably between A. Joseph Geist, trustee respondent, and the Prudence Realization Corporation, successor of The Prudence Company, Inc., debtor, the two holders of the mortgage security (evidenced by the participation certificates),

thereby disregarding and ignoring the default committed by the guarantor debtor, The Prudence Company, Inc., debtor, in violation of the equitable rule existing between guarantor debtors and creditors, or shall the construction placed upon the contract (the participation certificates) by the Court of Appeals of the State of New York, the United States District Court for the Eastern District of New York, and the Circuit Court of Appeals for the Second Circuit, which give due consideration to the existing equitable principles, prevail and be applied.

The petitioner bases its application for a writ of certiorari on the palpably erroneous theory that the District Court and the United States Circuit Court of Appeals for the Second Circuit failed to apply the bankruptcy principles of equal distribution in distributing the assets of The Prudence Company, Inc., debtor.

The question before the court does not involve the distribution of the assets of The Prudence Company, Inc., debtor, among its general creditors in the proceeding pending for the reorganization of that corporation under Section 77B of the National Bankruptcy Act. It concerns itself solely with the validity and order of priority or subordination of the interest held by The Prudence Company, Inc., debtor, in the mortgage upon the premises of Amalgamated Properties, Inc., debtor, of which mortgage The Prudence Company, Inc., was also a guarantor. It is not a mere coincidence that The Prudence Company, Inc., debtor, is the holder of some of these participation certificates. That it contemplated holding or acquiring such certificates is clearly evidenced by the language incorporated in the certificates sold to the public (R. 36-37); but it is likewise evident that any certificates owned or thereafter reacquired by it would be subordinate in interest to the certificates sold to the public, for while it reserved to Prudence-Bonds Corporation the right to hold similar certificates for its account, it did not reserve that right to itself (R. 37). It is by virtue of the ownership of such junior participating certificates, aside from the relation-

ship created by virtue of its guaranty, that the creditors of The Prudence Company, Inc., debtor, are interested in the proceeding entitled "In the Matter of Amalgamated Properties, Inc., debtor".

Question Presented

The true question concisely stated is: Did the courts below err in holding that the well-settled law of the State of New York was determinative of the order of priority of the respective interests in the mortgage on the property of Amalgamated Properties, Inc., debtor? Petitioner contends that the courts below should not have followed the well-settled State law to the effect that the interest in the certificates held by The Prudence Company, Inc., debtor, was subordinate to the interest in the outstanding certificates which were sold to the public with the guaranty of The Prudence Company, Inc., debtor; and that the courts below should have held, contrary to the well-settled law, that the respective interests were on a parity.

We respectfully submit, however, that questions as to the validity, priority and subordination of the interests in a mortgage on the property of a debtor are necessarily governed by the law of the State and that the courts below properly and correctly applied the law of New York State as settled by the authoritative decisions of the New York Court of Appeals.

The determination of the court below is in accordance with the decisions of the Court of Appeals of the State of New York, in complete harmony with cardinal principles of administration of insolvent estates and consistent with the intention of the parties succinctly expressed in the participation certificates prepared and sold by The Prudence Company, Inc., with its guarantee.

See:

Harvard Law Review, Vol. LV, No. 2, Dec. 1941, p. 283.

See also:

In re Prudence Co., Inc., (2d Cir.) 82 F. (2d) 755, cert. den. 298 U. S. 685, 56 Sup. Ct. 958, 80 L. Ed. 1405.

A writ of certiorari should be denied because the participation certificates held by the Prudence Realization Corporation, the successor in interest of The Prudence Company, Inc., debtor, constitute a subordinate interest in the mortgage

(a) by the very terms of the participation certificates;

(b) by virtue of the default committed by the debtor guarantor, The Prudence Company, Inc.

POINT I

The existence of the debtor-creditor relationship precludes and estops The Prudence Company, Inc. and its successors in interest from asserting that the certificates held by it are on a parity with those held by the general public.

The Court of Appeals of the State of New York has reviewed the relationships arising out of the sale of guaranteed mortgage certificates to the public and has stated clearly and unequivocally that the ownership interest retained by guarantor companies is subject and subordinate to the certificates sold to the general public and that such guarantor companies are not entitled to share in the distribution of either interest or principal until the certificate holders are paid in full unless the certificates sold and delivered to the public, specifically and unequivocally, provide that the guarantor is entitled to share with the certificate holders in the distribution of the moneys received from the mortgagor. See *Pink* v. *Thomas*, 282 N. Y. 10, where the Court said:

"* * * *but if a mortgage company guarantees payment of certificates which it sells to third parties it is not entitled to share in the proceeds received from the sale of collateral until the third-party certificate holders are paid in full unless the certificates sold clearly provide that it retains such right* (Matter of Title & Mortgage Guaranty Company of Sullivan County, 275 N. Y. 347), *the underlying principle being that a mortgage company which sells participating certificates in a mortgage and itself guarantees them is in the position of a debtor, and the equitable rule existing between debtors and creditor applies.* On default and absence of sufficient funds to pay certificate holders other than itself in full it cannot share in the assets available until the certificate holders are paid in full. That is the law, and it is right. Having guaranteed the payment of the certificates it would be highly inequitable to permit it to step in and divert part of the security available to pay such certificate holders whom it had expressly guaranteed should be paid. No one in this case questions that principle.

It should take very clear and unambiguous language in the certificates to overcome that rule and substitute a holding that in spite of its guarantee of payment it should be permitted to share in the available assets even though the certificates which it had guaranteed should be paid remained unpaid. Such an inequitable result could be accomplished if the language used was so clear and unmistakable that the courts would be compelled to give effect to the intent of the parties as expressed in the writing. Otherwise the equitable rule should prevail." (Italics supplied.)

See also:

In re Union Guarantee & Mortgage Co., 285 N. Y. 337, 34 N. E. (2d) 245.

POINT II

The decisions of the Court of Appeals of the State of New York are determinative of the validity, priority or subordination of the interests owned by The Prudence Company, Inc., debtor, and A. Joseph Geist, trustee respondent, in the mortgage upon the property of Amalgamated Properties, Inc., debtor.

See:

Lerner Stores Corporation v. *Electric Maid Bake Shops,* (5 Cir.) 24 F. (2d) 780, 782.

"* * *, if the property in the hands of the trustee is covered by two liens under the state law, it is necessary to determine which takes precedence, and the order of the liens fixed by the state law will be enforced. Preetorius v. Anderson (C. C. A.) 236 F. 723."

In *Re Knox-Powell-Stockton Co.,* (9 Cir.) 100 F. (2d) 979, at page 982:

"The laws of the state where the adjudication is had are controlling as to the validity and extent of the lien. York Mfg. Co. v. Cassell, 201 U. S. 344, 26 S. Ct. 481, 50 L. Ed. 782; Hiscock v. Varick Bank, supra; Marshall v. State of New York, 254 U. S. 380, 41 S. Ct. 143, 65 L. Ed. 315."

See:

General Motors Acceptance Corporation v. *Coller,* (6 Cir.) 106 F. (2d) 584, cert. den. 60 Sup. Ct. 723, 309 U. S. 682, 84 L. Ed. 1026.

The bankruptcy rules of equal distribution generally applied in insolvency proceedings is inapplicable where the parties actually intended to subordinate their claims and any attempt to compel the certificate holders or the trustee respondent to surrender any superior right they

hold without adequate compensation is inequitable and unfair (*St. Louis Union Trust Co.* v. *Champion Shoe Machinery Co.*, [8 Cir.] 109 F. [2d] 313).

The same result found by the court below will be reached by determining that special equities exist in favor of the certificate holders or by finding that an actual agreement exists to subordinate the defaulted guarantor's claim to those certificates sold to the public (*Bird & Sons Sales Corp.* v. *Tobin*, [8 Cir.] 78 F. [2d] 371, 100 A. L. R. 654).

POINT III

The Federal Court should follow and apply the decisions of the Court of Appeals of the State of New York.

The United States Circuit Court of Appeals for the Second Circuit and the United States District Court for the Eastern District of New York properly applied the principles enunciated in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188, 114 A. L. R. 1487.

The Circuit Court of Appeals for the Second Circuit in *In re Prudence Company, Inc.*, 82 F. (2d) 755, cert. den. 298 U. S. 685, 56 S. Ct. 787, followed and applied the decisions of the Court of Appeals of the State of New York construing contracts existing between The Prudence Company, Inc., and Prudence-Bonds Corporation with the certificate holders as contracts made and to be performed in the State of New York and therefor governed by the laws of the State of New York or the decisions of the Court of Appeals. See page 757:

> "The contract was made and was to be performed in New York concerning trust property there. We adopt the construction of the highest court in that state as to its meaning and effect. Hiscock v. Varick Bank, 206 U. S. 28, 27 S. Ct. 681, 51 L. Ed. 945; Prudential Ins. Co. of America v. Liberdar Holding Corporation (C. C. A.) 72 F. (2d) 395."

POINT IV

The petition for a writ of certiorari should be denied.

Respectfully submitted,

A. Joseph Geist,
Attorney for Respondent.

Morris A. Marks,
George E. Netter,
of Counsel.

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

PRUDENCE REALIZATION CORPORATION,
Petitioner,

against

A. JOSEPH GEIST, Trustee.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF ON BEHALF OF A. JOSEPH GEIST, TRUSTEE

A. JOSEPH GEIST,
Attorney for Respondent.

MORRIS A. MARKS,
GEORGE E. NETTER,
A. JOSEPH GEIST,
of Counsel.

TABLE OF CONTENTS

CASES CITED

TEXTS

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

Prudence Realization Corporation,
Petitioner,

against

A. Joseph Geist, Trustee.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit

BRIEF ON BEHALF OF A. JOSEPH GEIST, TRUSTEE

Jurisdiction

The appellant, Prudence Realization Corporation, by permission of this Court, writ of certiorari granted January 5, 1942 (R. 149), appeals from the determination of the United States Circuit Court of Appeals for the Second Circuit, dated August 11, 1941 (R. 129), which affirmed (Circuit Judge Frank dissenting) the decision of District Judge Grover M. Moscowitz (Eastern District of New York), dated January 5, 1941 (R. 123-125), and the order entered thereon dated January 30, 1941 (R. 125-126), decreeing that certain guaranteed mortgage certificates held by Prudence Realization Corporation, the successor in interest of The Prudence Company, Inc., the guarantor, are subordinate in interest to the certificates sold to and held by the general public.

Statement of Facts

The Prudence Company, Inc., a banking corporation organized under the laws of the State of New York, loaned $480,000 to Zo-Gale Realty Co., Inc., the then owner of premises 202 Riverside Drive, in the Borough of Manhattan, City of New York, and received the bond of that corporation secured by a mortgage on the property owned by it. The due date of said bond secured by the mortgage was subsequently extended to April 1, 1935, and the principal indebtedness eventually was reduced to $390,000 (R. 4).

The Prudence Company, Inc., the mortgagee, upon the receipt from Zo-Gale Realty Co., Inc., of said bond and mortgage, assigned them immediately to an affiliated corporation, Prudence-Bonds Corporation, without receiving any consideration therefor (R. 4). The stock of The Prudence Company, Inc., and of Prudence-Bonds Corporation was held by a parent corporation, New York Investors, Inc. (R. 118). The Prudence Company, Inc., sold to the public guaranteed mortgage certificates using a well-designed scheme and plan to facilitate the sale of those certificates.

Prudence-Bonds Corporation, upon transfer to it of the Zo-Gale bond and mortgage, deposited the securities with a depositary and issued its registered Prudence First Mortgage Certificates or bonds (see specimen, R. 5) in such denominations as were requested and specified by The Prudence Company, Inc., and delivered them to The Prudence Company, Inc., without receiving any consideration therefor (R. 16-117).

This completed the circuit. The certificates were guaranteed by The Prudence Company, Inc., and sold by it to the public. The proceeds of sale went into the treasury of The Prudence Company, Inc., and it was not required to, nor did it, account to Prudence-Bonds Corporation for any part of the proceeds of sale (R. 118).

[3] In the normal course of events, The Prudence Company, Inc., sold \$382,000 of the Zo-Gale certificates to the general public, leaving \$7,200 unissued certificates with Prudence-Bonds Corporation subject to call by The Prudence Company, Inc. (R. 6-118). In 1932, The Prudence Company, Inc., repurchased two certificates aggregating \$800, and as a result of various cancellations became entitled to a certificate for \$16.67, a total of \$816.67 (R. 6-118). The appeal concerns the unissued certificates of \$7,200 and the reacquired certificates of \$816.67.

The following is the chronological history of the orders entered in the instant consolidated proceedings:

(1) February 1, 1935, a petition for the reorganization of The Prudence Company, Inc., was filed and approved (R. 4-19).

(2) March 17, 1936, a petition for the reorganization of Amalgamated Properties, Inc., was approved as properly filed in the reorganization proceeding of The Prudence Company, Inc., Debtor (R. 4-21):

(3) February 19, 1938, an order of confirmation was duly made and entered in the Zo-Gale Issue (R. 5).

(4) April 9, 1938, an order of consummation was duly made and entered in re Zo-Gale Issue (R. 7) and A. Joseph Geist, respondent, duly qualified as trustee and acquired title to the bond and mortgage for the benefit of the certificate holders.

(5) May 26, 1939, order confirming plan of reorganization of The Prudence Company, Inc., proposed by the Reconstruction Finance Corporation (R. 22).

The order of confirmation in the Zo-Gale Issue was entered on the 19th day of February, 1938, in the United States District Court for the Eastern District of New York, more than one year before the confirmation of the

plan proposed by the Reconstruction Finance Corporation for the reorganization of The Prudence Company, Inc. Both plans were heard before the same District Judge. The order of February 19th specifically reserved the question of parity (R. 5, 6) of the certificates sub judice.

The amended plan for reorganization of The Prudence Company, Inc., Debtor, as proposed by the Reconstruction Finance Corporation, dated April 12, 1938, with amendments, and as confirmed by the order of District Judge Grover M. Moscowitz (Eastern District of New York), dated May 26, 1939 (R. 64-113), in order to comply with the reservation contained in paragraph 7 of the order of confirmation entered in the Zo-Gale issue on February 19, 1939 (R. 6), and recognizing that by virtue of that order certain assets in the portfolio of The Prudence Company, Inc., Debtor, to wit, unissued or repurchased mortgage certificates in "particular" issues were not on a parity "with other certificates of such issue". See Article IV, "Disposition of the New Company's Assets", paragraph 2(ii) and paragraph 2-a (R. 81-82), wherein it is specifically provided:

> 2(a) "* * * no definitive proration should be made of the value of the Collateral or other security for a particular certificate issue, due to uncertainty whether certificates of such issue held in the Debtor's estate on the Effective Date are on a parity with other certificates of such issue, *the deduction to be made pursuant to the foregoing clause (1) shall be based in the first instance on the assumption that the certificates so held in the Debtor's estate are not entitled to parity,* and an appropriate reserve shall be established by the New Company to provide for the additional distribution to be made to certificate-holders of such issue if the Board of Directors shall be later satisfied that such parity exists; the Board of Directors being authorized to discontinue such reserve if and when satisfied that such parity does not exist". (Emphasis supplied.)

The subordination of the Zo-Gale certificates is thus provided for under the very plan for reorganization of

The Prudence Company, Inc., in accordance with the Bankruptcy Statutes. The questions for the Court's consideration arise in the plan of the reorganization of Amalgamated Properties, Inc., Debtor, not the plan of reorganization of The Prudence Company, Inc., Debtor, where the order (R. 125-126) was made and entered declaring the certificates subordinate.

The order of confirmation entered in the consolidated proceeding for the reorganization of The Prudence Company, Inc., Debtor, did not nor could it alter or amend the parity question reserved in the order of confirmation entered in the Zo-Gale proceeding in the matter of Amalgamated Properties, Inc., Debtor, on the 19th day of February, 1938, nor was any attempt made in the consolidated proceedings for the reorganization of The Prudence Company, Inc., Debtor, to procure an order amending the order of confirmation in the Zo-Gale proceedings.

The District Court Judge, who heard both plans, said in his opinion: "No claim of waiver can properly be asserted by the respondent (Prudence Realization Corporation) since this question of parity has at all times been reserved" (R. 124). The reservations set forth in the order of confirmation in the plan for the reorganization of The Prudence Company, Inc., Debtor, Article IV, paragraph 2(a) (R. 82) should also be noted.

This proceeding was instituted in the United States District Court, Eastern District of New York, by A. Joseph Geist, trustee, pursuant to the reservation provision of the order of confirmation in the Zo-Gale issue entered February 19, 1938 (R. 6, 9).

The status of The Prudence Company, Inc., and its relationship with Prudence-Bonds Corporation has been the subject of discussion and review by the Federal Court and the courts of the State of New York. In *In re The Westover*, 82 Fed. (2d) 177, the trustees of The Prudence Company, Inc., Debtor, appealed from an order reducing a claim filed by them as trustees in the reorganization of Westover, Inc., which acquired title to premises No. 253-263 West

72nd Street, New York City. The pertinent facts are set forth in the following extract from the unanimous opinion of affirmance of the United States Circuit Court of Appeals for the Second Circuit, per Chase, C. J., at pages 177-178:

> "The appellants are the trustees of the Prudence Company, Inc., itself a corporation being reorganized under section 77B of the Bankruptcy Act (11 U. S. C. A. § 207). The issues here involved have arisen out of transactions which may be summarized as follows:
>
> The Westover, Inc., the corporate debtor in these proceedings, acquired the title in fee to a parcel of land located at 253-273 West Seventy-Second Street in New York City subject to several mortgages given by former owners in the aggregate principal amount of $1,300,000. On August 12, 1926, the debtor executed an additional mortgage on the premises in the principal amount of $100,000. All of these mortgages were merged in a consolidated first mortgage in the principal amount of $1,400,000 by agreement between the debtor and the Prudence Company, Inc., which purchased the mortgages with its own funds. Afterwards, and on February 10, 1927, the Prudence Company, Inc., assigned these mortgages, so consolidated, together with the bonds secured by them, to Prudence-Bonds Corporation, which is also being reorganized under Section 77B. It will be convenient to refer hereafter to these bonds and mortgages simply as the mortgage. *Prudence-Bonds Corporation paid nothing for the assignment. It was wholly controlled by stock ownership by the same interests which owned all the stock of the Prudence Company, Inc. and took the assignment in furtherance of an arrangement between the Prudence Company, Inc., and itself whereby it would issue participating certificates in the mortgage to be delivered by it to the Prudence Company, Inc., for sale to the investing public.* In carrying out this arrangement Prudence-Bonds Corporation did issue such certificates to an amount of $177.22 less than the principal sum of the mortgage and delivered them to the Prudence Company, Inc. The latter company then sold all of such certificates except $23,400 in face value which it retained and the appellants now hold as its trustees * * *." (Emphasis supplied.)

In that proceeding, which is on all fours with the facts in the instant case, there was no dispute that the uncertificated unsold portion of the mortgage was owned by The Prudence Company, Inc.

The Prudence Company, Inc., in the Zo-Gale Issue, as in *In re The Westover,* supra, retained for itself the uncertificated portion of the mortgage which had not been sold to the public, as well as the certificates which it reacquired. It was never intended that Prudence-Bonds Corporation should be deemed the owner of the bond and mortgage assigned to it pro forma.

In *In re Prudence Co.,* 89 Fed. (2d) 689, the Circuit Court of Appeals, Second Circuit, in reviewing an appeal from a decision of the District Court of the United States for the Eastern District of New York relative to the "Lerber Construction Corporation Issue", reviewed the history of participation certificates sold to the general public, the relationship existing between Prudence Company, Inc., and Prudence-Bonds Corporation, and recognized the undisputed fact that Prudence-Bonds Corporation did not pay any consideration for the assignment to it of the bond and mortgage pertinent and considered in that proceeding. We quote from the unanimous opinion of that Court at pages 690, 691:

> "January 9, 1931, a bond and mortgage were executed and delivered to the Prudence Company, Inc., for the principal sum of $675,000., bearing interest at 6 per cent. on premises in the Borough of Bronx, City of New York. July 30, 1931, the Prudence Company, Inc., assigned the bond and mortgage to the Prudence-Bonds Corporation which in turn assigned them to the Bank of Manhattan Trust Company as depositary under a deposit agreement. * * *
>
> Thereafter the Prudence-Bonds Corporation issued to the Prudence Company, Inc., participation certificates bearing interest at 5½% per cent. and the Prudence Company, Inc., sold these certificates to the general public along with its guaranty of principal and interest. * * *

We have already given a general outline of the series of agreements which led up to the issuance of the certificates. They must be looked at as steps in the accomplishment of a single plan. *First there was the assignment of the bond and mortgage without consideration to the Prudence-Bonds Corporation;* * * *." (Emphasis supplied.)

See also:

In re Prudence Co., 98 Fed. (2d) 559, 560;
In re Prudence-Bonds Corporation, 79 Fed. (2d) 212, pp. 216-217.

The inescapable conclusion is that The Prudence Company, Inc., at all times was the owner of the unissued certificates in the various issues, including the Zo-Gale Issue, and that Prudence-Bonds Corporation had no interest in such certificates whatever. A fortiori, the relationship existing between The Prudence Company, Inc., the guarantor, and the certificate holders was that of guarantor, vendor and guaranteed vendees, or, debtor and creditors.

See, also, *In re The Prudence Co., Inc.*, 82 Fed. (2d) 755 (C. C. A. 2), cert. den. 298 U. S. 685, 56 S. Ct. 787, where, in a like situation as here, the Court declared that the mortgages constituted the property of The Prudence Company, Inc., delivered to Prudence-Bonds Corporation in consideration of the issuance by the Prudence-Bonds Corporation of bonds or certificates, part of the plan for the sale of certificates to the public:

> "Each of the appellants is the trustee under one or more trust agreements executed by Prudence-Bonds Corporation under which certain mortgages on real estate and other securities were assigned to the appellants to hold in trust upon the terms stated for the benefit of the owners of bonds issued by Prudence-Bonds Corporation in accordance with the trust agreements. *All these securities had been the property of this debtor who had transferred them to Prudence-*

Bonds Corporation in consideration for the bonds issued by Prudence-Bonds Corporation which were delivered to the debtor." (Emphasis supplied.)

As between The Prudence Company, Inc., and Prudence-Bonds Corporation, it cannot be gainsaid that the certificates constituted the property of The Prudence Company, Inc. This very argument was advanced by The Prudence Company, Inc., Debtor in that case (see opening paragraph of the Court's opinion at p. 757).

Questions Presented

The following questions are presented for review and determination by this Court:

1) Shall the assets of Amalgamated Properties, Inc., Debtor in the Zo-Gale Issue, be distributed ratably without classification between the trustee, representing the guaranteed mortgage certificate holders, and The Prudence Company, Inc., debtor-guarantor, holder of similar certificates, the guarantor having defaulted in performing and fulfilling its guaranty, in the absence of a specific agreement, reserving to such guarantor the right to hold such certificates on a parity with those sold to the public?

1-a) Do the obvious equities estop the defaulted guarantor-debtor from sharing equally in the distribution of the assets available for distribution among the creditors of Amalgamated Properties, Inc., Debtor?

2) Did the Court below err in adhering to the interpretation and construction of the guaranteed mortgage certificates contract of the Court of Appeals of the State of New York (the situs of the contract), which decreed that guaranteed mortgage certificates owned by a defaulted guarantor-debtor are not on a parity with those held by certificate holders generally unless such right is specifically reserved to the guarantor in such certificates sold to the public by the guarantor?

POINT I

The existence of the debtor-creditor relationship precludes and estops The Prudence Company, Inc., and its successors in interest from asserting that the certificates held by it are on a parity with those held by the general public.

The Court of Appeals of the State of New York in reviewing the relationships created by and arising out of the sale of guaranteed mortgage certificates to the public has come to the clear and unequivocal conclusion that ownership interests retained by or reacquired by guarantor companies are subject and subordinate to the certificates sold to the general public and that such guarantor companies are not entitled to share in the distribution of either interest or principal until the certificate holders are paid in full unless the certificates sold and delivered to the public clearly, specifically and unequivocally provide that the guarantor is entitled to share with the certificate holders in the distribution of the moneys received from the mortgagor.

The proceedings at bar are on all fours with the case of *Pink* v. *Thomas*, 282 N. Y. 10. There, the Superintendent of Insurance of the State of New York, as liquidator of the Lawyers Title Guaranty Company, sought to have a certificate which it purchased, as well as the unissued portion of that certificated mortgage which it retained, declared to be on a parity with the guaranteed mortgage certificates which it sold to the public with its guarantee. The Court of Appeals emphatically and conclusively declared that the equitable principles existing between the guarantor-debtor in default and the certificate holder creditors estop the Superintendent of Insurance, as liquidator, from sharing in the assets available for distribution until the certificate holders are paid in full. We quote from the opinion of the Court:

"The Lawyers Title and Guaranty Company owned a mortgage for $42,300. It sold participating certificates therein to third parties to the amount of $40,475. It repurchased one $100 certificate. It at all times retained an interest of $1,825 in the mortgage. The company is now in liquidation. The question presented for determination is whether the plaintiff, as liquidator, is entitled to share pro rata in the proceeds to be received from the mortgaged property with the third parties holding participating certificates. The mortgage company guaranteed to certificate holders the payment of the certificates. If it had not guaranteed the payment of the certificates it would be entitled to share pro rata with the certificate holders in the proceeds of the sale of the mortgaged property (Title Guarantee & Trust Co. v. Mortgage Commission, 273 N. Y. 415), *but if a mortgage company guarantees payment of certificates which it sells to third parties it is not entitled to share in the proceeds received from the sale of collateral until the third-party certificate holders are paid in full unless the certificates sold clearly provide that it retains such right* (Matter of Title & Mortgage Guaranty Company of Sullivan County, 275 N. Y. 347), *the underlying principle being that a mortgage company which sells participating certificates in a mortgage and itself guarantees them is in the position of a debtor, and the equitable rule existing between debtors and creditor applies.* On default and absence of sufficient funds to pay certificate holders other than itself in full it cannot share in the assets available until the certificate holders are paid in full. That is the law, and it is right. Having guaranteed the payment of the certificates it would be highly inequitable to permit it to step in and divert part of the security available to pay such certificate holders whom it had expressly guaranteed should be paid. No one in this case questions that principle.

It should take very clear and unambiguous language in the certificates to overcome that rule and substitute a holding that in spite of its guarantee of payment it should be permitted to share in the available assets even though the certificates which it had guaranteed should be paid remained unpaid. Such

an inequitable result could be accomplished if the language used was so clear and unmistakable that the courts would be compelled to give effect to the intent of the parties as expressed in the writing. Otherwise the equitable rule should prevail." (Emphasis supplied.)

The Prudence Company, Inc., occupies the identical position and relationship to the guaranteed holders of the Zo-Gale Issue that existed between the Lawyers Title Guaranty Company and its guaranteed mortgage certificate holders. The Court of Appeals refused to construe the certificates issued by the Lawyers Title Guaranty Company as reserving to the guarantor the right to hold similar certificates on a parity with those sold to the certificate holders, and said at page 13:

> "* * * the wording of the certificate does not require the holding contended for by the respondent (Superintendent of Insurance)",

and reversed the judgment of the Appellate Division.

The Zo-Gale certificates were drawn with great care and skill. The precise and concise words incorporated in the certificates were selected with meticulous care and fine discrimination, and their meaning is clear and obvious. The certificates conspicuously omit the reservation in favor of The Prudence Company, Inc., as the guarantor, which would have given it the right to hold similar shares for its own account, but they do specifically reserve that right to Prudence-Bonds Corporation, which is described in the certificates as the "corporation" (Exhibit 1, R. 11-12, 115-116). And then, to emphasize that whatever rights were reserved are specifically defined, the certificates provide that certain rights are reserved "to the corporation and/or guarantor". Particularly the certificates provide in paragraph 4 thereof that only "the corporation (Prudence-Bonds Corporation), may for its own corporate account, be the holder or pledgee of similar shares in the said bond and mortgage" (R. 11).

The Court of Appeals in *Title Guarantee & Trust Co.* v. *Mortgage Commission,* 273 N. Y. 415, carefully considered the relationship created by the sale of a mortgage certificate by a company other than the guarantor, and there held that since the relationship of debtor and creditor did not exist, the Title Guarantee & Trust Company, as distinguished from the Bond & Mortgage Guarantee Company, the guarantor, with other certificate holders, became with them tenants in common, each entitled to an alliquot share of the mortgage referred to in the certificate.

The decision of the Court of Appeals is specifically limited to the facts in that case. See *In re Title & Mortgage Guaranty Company,* 275 N. Y. 347, where the Superintendent of Insurance, as liquidator of the Title & Mortgage Guaranty Company, upon the judicial settlement of the account of a trustee, sought to share as the holder of an unissued portion of a mortgage pro rata with the holders of the guaranteed mortgage certificates of that issue. The Court denied the claim of the liquidator, specifically declaring that the holders of the guaranteed mortgage certificates had a prior right to payment in full out of the proceeds of the mortgage.

In *In re Union Guaranty & Mortgage Co.,* 285 N. Y. 337, 34 N. E. (2d) 245), the Court said at page 343:

> "The principles of law applicable to the assignment of a prior interest in a mortgage are found in the decisions of this court. * * * *In Matter of Title Guaranty and Trust Company* v. *The Mortgage Commission* (273 N. Y. 415) * * *. Where, however, '* * * a debtor-creditor relation exists between an assignor of part of a mortgage and the assignee thereof, the assignee's claims must be satisfied before the assignor's.' (*Matter of New York Title and Mortgage Company; Matter of People by Van Schaick* [Series C-2], 253 App. Div. 308; affd., 278 N. Y. 488.)
>
> This rule was followed in the case of *Pink* v. *Thomas* (282 N. Y. 10). In order to avoid this rule an assignor of a part of a bond and mortgage or other assignable chose in action, may, by the terms of the

assignment, fix the right and interests of the assignor and assignee. Thus the rights of the certificate holders to preference may rest not only upon the presumption of intent derived from the guaranty of the assignor, *but also may be determined from the actual intent shown by the provisions of the agreement between the assignor and assignee.* (*Matter of Title & Mortgage Guaranty Co.* [*Pink*], 275 N. Y. 347.)" (Emphasis supplied.)

In *Matter of Weill*, 253 App. Div. 308, affirmed without opinion 278 N. Y. 488, referred to on pages 18 and 19 of the appellant's brief, the Court held that there was no intention on the part of the New York Title Mortgage Company to cancel certain of its guaranteed mortgage certificates, which it repurchased, particularly since the certificates explicitly provided:

> "This certificate is one of a series of certificates * * * wherein the Company covenants * * * and hereby agrees to and with each and every holder of this certificate, as follows: That there shall be no preference or priority in favor of any share in the deposited bonds and mortgages * * * or of any certificate of interest. * * *
>
> * * * * * * *
>
> 2. The Company may be the holder or owner or pledgee of one or more of the said certificates."

The depositary agreement provides:

> "8. There shall be no preference or priority in favor of any share in the deposited bonds and mortgages * * * or of any certificate of interest representing the same, as against any other share or certificate, whether held by the Title and Mortgage Company or by any other holder; but each share shall participate equally with every other share in the deposited bonds and mortgages * * *",

and the certificates therefore were properly determined to be on a parity with all the other outstanding certificates, and for those reasons the Court said that the certificates "should be regarded as a substitute for such of the general assets as was used to purchase them" (p. 310).

A close examination of the guaranteed mortgage certificate and the guaranty agreement executed by The Prudence Company, Inc., leads to the inevitable conclusion that an actual agreement exists between The Prudence Company, Inc., and the certificate holders subordinating the claims of The Prudence Company, Inc., to those of the certificate holders and should be decreed so by this Court (*Thomas* v. *Pink*, supra). The Prudence Company, Inc., under its agreement of guaranty, "* * * guarantees to each and every holder of the certificates of participation * * *

> First: Payment of interest when due according to the terms of each such certificate issued.
>
> Second: Payment of the principal, and of every installment thereof, as soon as collected, but in no event later than eighteen months after it shall have become due and payment thereof shall have been demanded in writing by the insured, with regular payment meantime of interest at the rate guaranteed" (R. 12-13).

The Circuit Court of Appeals in its decision in the case at bar said (122 Fed. [2d] 503; R. 132-136):

P. 132.

> "And if we thus found the guarantee to amount to an actual agreement between two creditors that the claim of one against the debtor should be subordinated to that of the other, we should give that effect to it, as was done in *St. Louis Union Trust Co.* v. *Champion Shoe Machinery Co.,* 8 Cir., 109 F. 2d 313; *Bird & Sons Sales Corp.* v. *Tobin,* 8 Cir., 78 F. 2d 371, 100 A. L. R. 654; and *Searle* v. *Mechanics' Loan & Trust Co.,* 9 Cir., 249 F. 942, *certiorari* denied 248 U. S. 592, 39 S. Ct. 67, 63 L. Ed. 437 * * *."

P. 133:

> "Where the state law determines what the actual agreement made by the parties is, and therefore the real basis of their claims in bankruptcy, it must be given effect."

P. 136.

"Moreover, these appear to be no particular equities in favor of either the original guarantor or those who claim through it, including its successor * * * which took with full notice of the situation from the reorganization proceedings generally and especially in view of the explicit reservation of the question in the confirmation of the debtor's reorganization."

P. 136.

"Under *Pink* v. *Thomas, supra, an actual agreement against parity might well be found.*" (Emphasis supplied.)

See:

In re Title & Mortgage Guaranty Company, supra.
Harv. L. Rev., Vol. LV, No. 2, Dec. 1941, p. 283, Note

The petitioner discusses at great length the relative position of the creditors of The Prudence Company, Inc., and devotes much of its brief to this alien question. We are here concerned with the creditors of Amalgamated Properties, Inc., and it cannot be gainsaid that all the equities are overwhelmingly in favor of the guaranteed mortgage certificate holders of the Zo-Gale Issue and that none of them lie with the guarantor, The Prudence Company, Inc.

See:

Pink v. *Thomas*, supra;
In Matter of Title & Mortgage Guaranty Company, supra;
Title Guarantee & Trust Co. v. *Mortgage Commission*, supra;
In re The Westover, supra;
In re The Prudence Company, Inc., supra.

The bankruptcy theory and rules of equal distribution generally applied in insolvency proceedings are inapplicable where special equities exist. See: *Sampsell* v. *Imperial Paper & C. Corp.*, 313 U. S. 215, 221, 61 S. Ct. 904, 85 L. Ed. 1293, where this Court said:

> "The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete. Taylor v. Standard Gas & E. Co., 306 U. S. 307, 83 L. ed. 669, 59 S. Ct. 543, 38 Am. Bankr. Rep. (N. S.) 692; Pepper v. Litton, 308 U. S. 295, 84 L. ed. 281, 60 S. Ct. 238, 41 Am. Bankr. Rep. (N. S.) 279; Bird & Sons Sales Corp. v. Tobin (C. C. A. 8th), 78 F. (2d) 371, 100 A. L. R. 654, 29 Am. Bankr. Rep. (N. S.) 171."

See, also:

St. Louis Union Trust Co. v. *Champion Shoe Machinery Co.* (8th Cir.), 109 Fed. (2d) 313;
Bird & Sons Sales Corp. v. *Tobin* (8th Cir.), 78 Fed. (2d) 371, 100 A. L. R. 654.

The application of this principle, however, should not be confused with erroneous attempts to administer insolvency proceedings in accordance with local laws contrary to the provisions of the Bankruptcy Law.

Yonkers v. *Downey, Receiver*, 309 U. S. 590, 597, 60 S. Ct. 796, 84 L. Ed. 964;
Jennings, Receiver v. *United States Fidelity & Guarantee Co.*, 294 U. S. 216, 55 S. Ct. 394, 79 L. Ed. 869, 99 A. L. R. 1248.

The trustees of The Prudence Company, Inc., actively participated in the Amalgamated Properties, Inc. proceeding. They acquiesced to the reservation proviso; the Court had jurisdiction of all the parties and the collateral attack attempted here will not lie. Cf. *Stoll* v. *Gottlieb*, 305 U. S. 165, 59 S. Ct. 134, 83 L. Ed. 104.

A Review of the Contentions Urged by the Petitioner

The petitioner urges in Point V of its brief that the certificates are entitled to parity in any event because they were originally in the name of Prudence-Bonds Corporation and transferred to the trustees of The Prudence Company, Inc., Debtor, as a compromise pursuant to an order of the District Court. That contention was urged and disposed of in the opinion of District Judge Moscowitz, who heard and passed upon the plans of reorganization of both Amalgamated Properties, Inc., Debtor, and The Prudence Company, Inc., Debtor:

> "The difficulty with the respondent's analysis rests in the assumption that its uncertificated interest was derived from the reorganization compromise and that the compromise agreement implied parity. Actually, however, the uncertificated interest of the respondent was not wholly derived in that manner. It should be remembered that the assignment of mortgage from Prudence to Prudence Bonds was without consideration, and that therefore, to the extent that mortgage certificates were not delivered by Prudence Bonds to Prudence, the real ownership, as between the parties, remained in Prudence. When, therefore, in connection with the reorganization compromise, Prudence Bonds released to Prudence any interest it might have in the uncertificated portion of the mortgage, that release did not effect the transfer to Prudence of any substantial interest that it did not already have as against Prudence Bonds. Accordingly, there is no basis for disregarding the rule set forth in Pink v. Thomas, supra" (R. 124).

The petitioner also stresses the decision of Judge Brower in *Matter of Southeast Corner of National Boulevard and West Broadway, Long Beach*, reported in the New York Law Journal January 31, 1940. The decision in that case is in complete harmony with the decisions of the Court of

Appeals. There, the Superintendent of Insurance, as liquidator of the Bond & Mortgage Guaranty Company, in the regular course of business, purchased a mortgage certificate from the Title Guarantee & Trust Company after the entry of the order for the rehabilitation of the Bond & Mortgage Guaranty Company. Since the relationship of debtor, guarantor and creditor did not exist, the Title Guarantee & Trust Company was entitled to have the certificates held by it declared on a parity with those held by the general public, and the purchase of such a certificate by the Superintendent of Insurance after the entry of the order of rehabilitation as a business transaction could not destroy the right to parity. The position of the petitioner, on the contrary, is singularly parallel to that of the Bond & Mortgage Guaranty Company prior to the entry of the order of liquidation—a guarantor-debtor in default, who did not reserve the right to and could not hold certificates on a parity with those sold to the general public.

The petitioner urges in Point III of its brief that the certificates held by it are on a parity with those held by the trustee because it owns Amalgamated Properties, Inc., and as a creditor of The Prudence Company, Inc., Debtor, accepted the stock of Amalgamated Properties, Inc., as security for a loan which it made to The Prudence Company, Inc. The Court of Appeals of the State of New York refused to recognize this contention in *Matter of Lawyers Title & Guaranty Company, Netacos Corporation*, decided January 15, 1942, published in the New York Law Journal February 20, 1942, 287 N. Y. 264, Vol. 146, Official Weekly Advance Sheets.

In that case, the Lawyers Title & Guaranty Company, prior to its liquidation, was the owner of a bond and mortgage in the principal amount of $75,000 which it sold with its guaranty on February 8, 1927 to Adele Kneeland, as executrix. Upon maturity of the mortgage, the property having been appraised for less than the mortgage,

the company paid $25,000 of the principal of the mortgage to the executrix and issued to her a guaranteed first mortgage participation certificate for $50,000. This guaranteed mortgage certificate, hereinafter referred to as certificate No. 1, was sold to the Netacos Corporation, the present holder thereof.

On January 26, 1933, the Reconstruction Finance Corporation loaned to the Lawyers Title & Guaranty Company a large sum of money, and as part of the collateral security for that loan received an assignment of a guaranteed mortgage certificate for $25,000, hereinafter referred to as certificate No. 3, the balance of the above described mortgage. When it appeared that the value of the property was insufficient to pay on liquidation the face value of the two certificates, the proceeding was instituted, Netacos Corporation urging that its certificate was superior in interest and priority over the certificate pledged with the Reconstruction Finance Corporation and that the liquidator of the Guaranty Company and the Reconstruction Finance Corporation had the right to receive only so much as may remain after paying principal and interest on the certificate held by the Netacos Corporation.

The Court of Appeals sustained the contention of the Netacos Corporation. The opinion of the Court follows:

> "Both Certificate No. 1 (originally sold to the Kneeland estate and later acquired by The Netacos Corporation) and Certificate No. 3 (pledged by the company to R. F. C.) contain a provision assigning to the holder thereof an undivided share in the bond and mortgage No. 'Q' 25088 'equal and co-ordinate with all other shares assigned or retained by the Company, the aggregate amount of all such shares, issued and retained, at no one time to exceed the amount then owing on said bond and mortgage'. We read the provision in the light of the explanation given in *Pink* v. *Thomas* (282 N. Y. 10, 13): 'As we know, these mortgage certificates are sold at different times to different individuals. The words "equal and coordinate with all other shares assigned or retained

by the Company" constitute an agreement that the shares in question shall be equal and co-ordinate with those previously *sold*. That is, that the date of *sale* of different shares shall not in any event constitute a preference, and the shares retained by the company at the date of the sale of any particular share are retained presumably for subsequent *sale*, as that was the business of the company. They shall, *when sold*, be equal and co-ordinate with those in question and all other shares previously *sold* or those still remaining and retained by the company to be thereafter *sold*. All shares taken together, that is, all those sold and all those unsold but retained for future sale, shall not exceed the amount at any time owing on the bond and mortgage'." (Emphasis supplied.) (See, also, *Matter of Title & Mortgage Guaranty Co.*, 275 N. Y. 347).

"It cannot be doubted that, under the rule of *Pink* v. *Thomas* (*supra*), if, instead of pledging Certificate No. 3, the company had retained that certificate for itself, Certificate No. 1 would be entitled to priority. Nor can there be doubt that if, instead of pledging Certificate No. 3, the company had *sold* that certificate to R. F. C., Certificate No. 1 would share in the security pro rata with Certificate No. 3. In the present proceeding, however, Certificate No. 3 was not sold—it was pledged to R. F. C. by the company as collateral to its loan. In that transaction R. F. C., as pledgee, acquired what may be termed a special property in the hypothecated certificate—a 'possessory right acquired under the bailment' (*McCoy* v. *American Express Co.*, 253 N. Y. 477, 482). But the general property—the legal title to the certificate—remained in the company as pledgor. (*Markham* v. *Jaudon*, 41 N. Y. 235, 240, 241; *Keller* v. *Halsay*, 202 N. Y. 588, 597. Cf. *Griffey* v. *New York Central Ins. Co.*, 100 N. Y. 417, 422; *Harding* v. *Eldridge*, 186 Mass. 39, 42.)

This proceeding and those involving similar problems call for a determination of the intention of the parties and a consideration of the natural equities involved. (*Matter of Title & Mortgage Guaranty Co.*, supra, pp. 354, 355; *Pink* v. *Thomas*, supra; *Matter of People* (*Union Guarantee & Mortgage Co.*), 285 N. Y. 337, 344.) The fact that we are dealing with a guaranty by the company bears upon those equities.

When the company offered to sell participation certificates in the mortgage here involved, it must have been the intention of the seller and the understanding of the buyer that only purchasers who placed themselves in positions akin to mortgagees would be entitled to the preferential benefits attaching to the guaranteed certificates. The sale of participating interests in mortgages was the business which engaged the company's efforts. Not only the mortgage security but the company's guaranty must have been intended as favorable competitive factors in the mortgage market. It is with that assumption in mind that we read the phrase common to Certificates Nos. 1 and 3 whereby the company assigned an undivided share in the bond and mortgage, 'Equal and co-ordinate with all other shares assigned or retained by the Company.' Thus read, and with proper regard for the ruling in *Pink v. Thomas* (supra), the quoted phrase refers to shares *sold* to a *purchaser* of the certificates, viz., to one who, by reason of the acquisition of the rights represented by the certificate, became entitled to participate in the mortgage security and any benefits arising from the guaranty *pro rata* with the purchasers of other participation certificates in the same mortgage, or their assignees.

We do not believe that when the company pledged Certificate No. 3 with R. F. C. as collateral to a loan, it granted to R. F. C. as pledgee the same rights as those to which a *purchaser* of other similar certificates was entitled. The company could pledge no rights in the certificate which it could not exercise itself. * * * The company cannot retain the legal title to the certificate—as it does as a pledgor (*Markham v. Jaudon*, supra, pp. 240, 241)—and enjoy additional rights or advantages solely by reason of the fact that it has pledged the certificate. * * *

The order of the Appellate Division should be modified to provide that Certificate No. 1 of mortgage No. 'Q' 25088 shall be entitled to priority over the interest of both the liquidator and R. F. C. in Certificate No. 3."

The petitioner in Point IV of its brief cites *In the Matter of The New York Title & Mortgage Company*, 163 Misc. 318, 296 Supp. 644, affirmed without opinion 254 App. Div.

722, 4 N. Y. Supp. (2d) 1004, in support of the proposition that the New York State courts have determined that certificate holders do not have a prior lien in a mortgage as against the guarantor which holds similar certificates. That decision does not support that theory. In that case, the petitioner, a trustee of a reorganized mortgage, sought to join the Superintendent of Insurance as a party defendant in an action to foreclose the mortgage "in order to determine therein whether the unsold portion belonging to the latter is junior, subordinate and inferior to the portion held by the trustees for the benefit of the certificate holders 'as if the petitioner held a first mortgage on said premises * * * and the * * * Liquidator * * * held a second mortgage on said premises', and (2) for the purpose of cutting off said liquidator's interest if it be held to be junior and subordinate" (p. 319).

The Court denied the application, declaring that there was no justification for treating what is actually a subordinate interest in a single first mortgage as if it were in fact a second mortgage, though it recognized that the certificates held by the Superintendent of Insurance were subordinate (p. 320):

> "The certificate holders and the liquidator both own interests in the same mortgage and the trustee holds title to the bond and mortgage on their respective behalves. The action seeks to foreclose the entire mortgage and not merely that part thereof which is represented by certificates. Since the trustee has title to the entire mortgage it must be deemed to hold the same in trust for the certificate holders and for the liquidator, as their interests may appear. Title to the whole mortgage vested in the trustee after it qualified as such under the plan of reorganization. There was no splitting up of the mortgage between the trustee and the liquidator. Nor could such a split up of a single obligation be effected without the consent of those liable upon the bond and mortgage.
>
> * * * In view of the fact that the certificate holders are entitled to priority over the uncertificated unsold portion, adjudication as to such priority to be obtained

on a proper application, no payments are to be made by the trustee on account of the unsold portion until the certificate holders have been paid in full. It does not follow, however, from the fact that the right of the liquidator to share in the proceeds of the mortgage is subordinate to that of the certificate holders that the unsold portion may be treated as if it were a second mortgage and cut off as such in a foreclosure action."

POINT II

The Federal Court should follow and apply the decisions of the Court of Appeals of the State of New York.

The issues submitted for determination arise out of a contract made between citizens of the State of New York, executed and to be performed in the State of New York. This contract involves a question of commercial general law, and does not involve the construction of either the Constitution of the United States or an Act of Congress. The Court is, therefore, bound and required to follow the decision of the Court of Appeals of the State of New York, the highest court of the State of New York, the State wherein the contract was made and the controversy arose. See *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 82 L. Ed. 1188, where Mr. Justice Brandeis, speaking for the Supreme Court of the United States, in overruling the doctrine long established by *Swift* v. *Tyson*, 16 Pet. 1, 18, 10 L. Ed. 865, 871, said:

> "Except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State. And whether the law of the State shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern. There is no federal general common law. Congress has no power to declare substantive rules of common law applicable in a State

whether they be local in their nature or 'general', be they commercial law or a part of the law of torts. And no clause in the Constitution purports to confer such a power upon the federal courts."

Mr. Justice Brandeis quoted and adopted a portion of the dissenting opinions of Mr. Justice Holmes in *Kuhn* v. *Fairmont Coal Co.*, 215 U. S. 349, 370-372, 54 L. Ed. 228, 238, 239, 30 S. Ct. 140; *Black & W. Taxicab & Transfer Co.* v. *Brown & Y. Taxicab & Transfer Co.*, 276 U. S. 518, 532-536, 72 L. Ed. 681, 686-688, 48 S. Ct. 404, 57 A. L. R. 426. We quote from *Erie R. Co.* v. *Tompkins*, supra, at page 1195:

"The fallacy underlying the rule declared in Swift v. Tyson is made clear by Mr. Justice Holmes. The doctrine rests upon the assumption that there is 'a transcendental body of law outside of any particular state but obligatory within it unless and until changed by statute,' that federal courts have the power to use their judgment as to what the rules of common law are; and that in the federal courts 'the parties are entitled to an independent judgment on matters of general law':

'But law in the sense in which courts speak of it today does not exist without some definite authority behind it. The common law so far as it is enforced in a State, whether called common law or not, is not the common law generally but the law of that State existing by the authority of that State without regard to what it may have been in England or anywhere else * * *

'the authority and only authority is the state, and if that be so, the voice adopted by the State as its own [whether it be of its Legislature or of its Supreme Court] should utter the last word.'"

"Laws" includes "decisions", said Mr. Justice Reed in *Erie R. Co.* v. *Tompkins*, supra.

The decision of the Court of Appeals of the State of New York contained in Point I constrains the Court to declare that the certificates held by The Prudence Realization Corporation, the successors in interest of the trus-

tees of The Prudence Company, Inc., Debtor, are not on a parity with those certificates sold and delivered by The Prudence Company, Inc., as guarantor, to the general public.

In the prevailing opinion, the Circuit Court of Appeals said:

> "If it is a rule of construction, we would follow it as we held in *In re Prudence Co., Inc.*, 2 Cir., 82 F. 2d 755, *certiorari* denied 298 U. S. 685, 56 S. Ct. 958, 80 L. Ed. 1405; and see, of course, *Erie R. Co. v. Tompkins*, 304 U. S. 64, 58 S. Ct. 817, 82 L. Ed. 1188, 114 A. L. R. 1487."

In *Prudence Company, Inc.*, 82 Fed. (2d) 755, cert. den. 298 U. S. 685, 56 S. Ct. 787, this Court followed and applied the decisions of the Court of Appeals of the State of New York construing contracts existing between The Prudence Company, Inc., and Prudence-Bonds Corporation with certificate holders as contracts made, executed and to be performed in the State of New York, and therefore governed by the laws of the State of New York or the decisions of the Court of Appeals. This in spite of the filing of petitions for reorganization of each of these corporations in the Federal Court under Section 77B of the Bankruptcy Act. See page 757:

> "The contract was made and was to be performed in New York concerning trust property there. We adopt the construction of the highest court in that state as to its meaning and effect. Hiscock v. Varick Bank, 206 U. S. 28, 27 S. Ct. 681, 51 L. Ed. 945; Prudential Ins. Co. of America v. Liberdar Holding Corporation (C. C. A.), 72 F. (2d) 395."

The Appellate Division of the State of New York in *In the Matter of New York Title & Mortgage Company*, supra, declared the interest held by the Superintendent of Insurance to be, "* * * actually a junior interest in a single mortgage * * *" (p. 320). The decisions of the

Courts of the State of New York are controlling as to the priority, validity and extent of the respective interests held by the guaranteed mortgage certificate holders and The Prudence Company, Inc., in the Zo-Gale Issue.

See:

> *Lerner Stores Corporation* v. *Electric Maid Bake Shops* (5th Cir.), 24 Fed. (2d) 780, 782.

> "* * *, if the property in the hands of the trustee is covered by two liens under the state law, it is necessary to determine which takes precedence, and the order of the liens fixed by the state law will be enforced. Preetorius v. Anderson (C. C. A.) 236 F. 723."

In *Re Knox-Powell-Stockton Co.* (9th Cir.), 100 Fed. (2d) 979, at page 982:

> "The laws of the state where the adjudication is had are controlling as to the validity and extent of the lien. York Mfg. Co. v. Cassell, 201 U. S. 344, 26 S. Ct. 481, 50 L. Ed. 782; Hiscock v. Varick Bank, supra; Marshall v. State of New York, 254 U. S. 380, 41 S. Ct. 143, 65 L. Ed. 315."

See:

> *General Motors Acceptance Corporation* v. *Coller* (6th Cir.), 106 Fed. (2d) 584; cert. den. 60 Sup. Ct. 723, 309 U. S. 682, 84 L. Ed. 1026.

POINT III

The decision of the Circuit Court of Appeals for the Second Circuit should be affirmed.

Respectfully submitted,

A. Joseph Geist,
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SUPREME COURT OF THE UNITED STATES.

No. 757.—October Term, 1941.

Prudence Realization Corporation, Petitioner, *vs* A. Joseph Geist, Trustee.	Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[April 27, 1942.]

Mr. Chief Justice Stone delivered the opinion of the Court.

The question for our decision is whether an insolvent defaulting guarantor of certificates of participation in a mortgage, who is also the owner of a part of the mortgage indebtedness, is entitled to share pro rata in a distribution of the proceeds of the mortgage in a § 77B bankruptcy reorganization.

Prudence Company, petitioner's predecessor, and a wholly owned subsidiary of New York Investors, Inc., loaned to Zo-Gale Realty Company $480,000 on its bond secured by a first mortgage on real estate. In 1925 Prudence Company put into execution a plan for selling participation certificates in the mortgage. It assigned the bond and mortgage without consideration to Prudence Bonds Corporation, also a wholly owned subsidiary of New York Investors, Inc. Prudence Bonds in turn lodged the bond and mortgage with a trust company depositary. Prudence Company then executed a guaranty of payment of the bond and mortgage, whereupon Prudence Bonds issued certificates of participation authenticated by the trust company, and totaling $382,800. It delivered them, without payment of any consideration, to the Prudence Company which then sold them to investors. The guaranty of Prudence Company, which was referred to in the participation certificates, was of payment of the bond interest when due and of the principal when due or within eighteen months thereafter.

Each certificate declares that the purchaser is entitled to an undivided share in the mortgage of a specified amount equal to the sum paid for it by the original purchaser. Each provides that the share in the bond and mortgage represented by it is not sub-

ordinate to any other shares or subject to any prior interest, and each reserves to Prudence Bonds the right "to be the holder or pledgee of similar shares" in the bond and mortgage. The mortgage indebtedness was later reduced to $390,000, leaving an undivided share of $7,200 of which Prudence Company wa the equitable owner, for which no participation certificate had been issued.

In 1938 an order of the bankruptcy court, in which Prudence Company and Prudence Bonds were then being reorganized, directed a transfer to Prudence Company of the $7,200 interest, as part of a settlement and adjustment of mutual claims between the two companies, and Prudence Company has continued to be the owner of this share of the mortgage indebtedness. It has also acquired by purchase from certificate holders $816.67 in certificates of participation in the mortgage.

On foreclosure of a second mortgage on the Zo-Gale property, Amalgamated Properties, Inc., a wholly owned subsidiary of Prudence Company, acquired title to the property from the mortgagor, and later went into a bankruptcy reorganization. Upon approval by the court of a plan of reorganization of the Zo-Gale certificate issue, the title to the mortgaged property was transferred to respondent Geist as trustee for the benefit of the certificate holders. In confirming the plan for reorganization of Amalgamated, the court reserved for future decision the question whether the Prudence Company was entitled to payment of its two claims in the mortgage pro rata with the other certificate holders.

As provided by the reorganization plan of Prudence Company, petitioner Prudence Realization Corporation was organized to take over the assets from the trustees of Prudence Company and to liquidate them for the benefit of creditors under the direction of the bankruptcy court. Petitioner has thus acquired certificates issued in the Amalgamated reorganization proceeding, representing the interest of Prudence Company in the Zo-Gale bond and mortgage. The claims against Prudence Company recognized by its plan of reorganization amounted to $133,723,000, including its guaranties of mortgages amounting to $12,523,000; guaranties of bonds issued by Prudence Bonds for $58,833,000; and guaranties of mortgage participation certificates issued by Prudence Bonds (including the Zo Gale mortgage certificates) for $50,858,000.

The present proceeding was begun by respondent's petition in the consolidated reorganization of Prudence Company and Amalga-

mated Properties in the Eastern District of New York for an order directing that petitioner was not entitled to any distribution on account of the Prudence Company's interest in the Zo-Gale mortgage until the other certificate holders were paid in full. The district court granted the order, which the Circuit Court of Appeals for the Second Circuit affirmed. 122 F. 2d 503. Both courts applied the rule of the New York Court of Appeals, see *Matter of Title & Mortgage Guaranty Co.*, 275 N. Y. 347; *Pink* v. *Thomas*, 282 N. Y. 10; *Matter of People* (*Union Guarantee & Mortgage Co.*), 285 N. Y. 337, that a guarantor of mortgage certificates, who also has an interest in the mortgage, cannot share in the proceeds of its collection until the certificate holders are paid, unless there is a clear reservation in the certificate of the right of the guarantor to share on a parity with other certificate holders. The Circuit Court of Appeals by a divided court held that it was bound to apply the rule announced in the New York cases cited, which it deemed to be a rule of construction of the guaranty of the certificates. We granted certiorari, 315 U. S. —, because of the importance in bankruptcy administration of the questions raised.

The court below recognized the implication of the requirement that a plan of reorganization under former § 77B(f)(1) of the Bankruptcy Act (see 11 U. S. C. § 621(2)) be one which "is fair and equitable and does not discriminate unfairly in the case of any class of creditors", see *Southern Pacific Co.* v. *Bogart*, 250 U. S. 483, 492; *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106, and that § 65(a) requires that in liquidations a distribution of "dividends of an equal per centum" shall be made "on all allowed claims, except such as have priority or are secured", see *Globe Bank* v. *Martin*, 236 U. S. 288, 305; *Moore* v. *Bay*, 284 U. S. 4. It recognized also that the equity powers of the bankruptcy court may be exerted to subordinate the claims of one claimant to those of others of the same class where his conduct in acquiring or asserting his claim is contrary to established equitable principles. See *Taylor* v. *Standard Gas Co.*, 306 U. S. 307; *Pepper* v. *Litton*, 308 U. S. 295; *In re Bowman Hardware & Electric Co.*, 67 F. 2d 792.

But the court found it unnecessary to choose between such competing considerations, and rested its decision on the ground that Prudence Company's guaranty of the certificates was under state law to be interpreted as impliedly agreeing that any claim of its own to the mortgage indebtedness was to be subordinated to those

of other certificate holders. After referring to cases in which the New York Court of Appeals had directed such a subordination, the court said (122 F. 2d 505):

"An important issue herein is whether this is primarily a rule of construction of the guaranty in the certificates or is a rule of administration of insolvent estates which violates bankruptcy principles of equal distribution of a bankrupt estate among creditors. If it is a rule of construction we would follow it . . .", citing *Erie Railroad* v. *Tompkins*, 304 U. S. 64. "And if we thus found the guarantee to amount to an actual agreement between two creditors that the claim of one against the debtor should be subordinated to that of the other, we should give effect to it . . ."

The only evidence of the actual intent of the parties to which the court referred was the fact that Prudence Company, unlike Prudence Bonds, had not reserved the right in the certificates to be the holder of "similar shares" in the bond and mortgage. But there is no contention that in the absence of such a provision in the certificates, Prudence Company was not free to acquire certificates or hold an interest in the guaranteed mortgage in its own right. Consequently, its ownership of the $816.67 in certificates and $7,200 of the uncertificated indebtedness evidences no actual intention to subordinate those interests in a liquidation. And neither the terms of the guaranty nor of the certificates give any indication of such an intent of the parties.

The court arrived at its conclusion that the Prudence Company had agreed to subordinate its claims, not from an examination of the relevant documents read in the light of the surrounding circumstances, except as we have noted, but from its reading and application of the opinions of the New York Court of Appeals. These recognize that the guarantor of a mortgage, who is also a part owner of it, is free to stipulate that he may share in a liquidation on an equal footing with other owners of the mortgage despite his default on his guaranty, and that effect will be given to such a stipulation. See *Matter of Title & Mortgage Guaranty Co., supra,* 352; *Pink* v. *Thomas, supra,* 12; *Matter of People (Union Guarantee & Mortgage Co.), supra,* 343. On the other hand, some of them have found visible evidence, in the terms of the certificates, of an actual intention of the parties to subordinate the guarantor's interest. To that extent they are inapplicable to the certificates in this case, which afford no such evidence. See *Matter of Title and Mortgage Guaranty Co., supra,*

355; *Matter of People (Union Guarantee & Mortgage Co.), supra,* 345.

But so far as the New York cases, without evidence of the actual intent of the parties, subordinate the guarantor on grounds of "presumed intention", or "the existence of special equities", or the "natural equities" involved, *Title Guarantee & Trust Co.* v. *Mortgage Commission,* 273 N. Y. 415, 426; *Matter of Title & Mortgage Guaranty Co., supra,* 355; *Pink* v. *Thomas, supra,* 12; *Matter of People (Union Guarantee & Mortgage Co.), supra,* 343; *Matter of Lawyers' Title & Guaranty Co.,* 287 N. Y. 264, 272, we are unable to say that the rule laid down is other than one of state law governing the relative rights of claimants in a state liquidation. Nothing decided in *Erie Railroad* v. *Tompkins, supra,* requires a court of bankruptcy to apply such a local rule governing the liquidation of insolvent estates. The bankruptcy act prescribes its own criteria for distribution to creditors. In the interpretation and application of federal statutes, federal not local law applies. See *Awotin* v. *Atlas Exchange Bank,* 295 U. S. 209; *Chesapeake & Ohio Ry.* v. *Martin,* 283 U. S. 209, 212-213; *Board of Comm'rs* v. *United States,* 308 U. S. 343, 349-350; *Deitrick* v. *Greaney,* 309 U. S. 190, 200; *Royal Indemnity Co.* v. *United States,* 313 U. S. 289, 296. The court of bankruptcy is a court of equity to which the judicial administration of the bankrupt's estate is committed, *Securities Commission* v. *U. S. Realty Co.,* 310 U. S. 434, 455-457, and it is for that court—not without appropriate regard for rights acquired under rules of state law—to define and apply federal law in determining the extent to which the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy requires its subordination to other claims which, in other respects, are of the same class. Cf. *Taylor* v. *Standard Gas Co., supra*; *Pepper* v. *Litton, surpra.*

But the question remains whether there is any equity arising from the Prudence Company's failure to perform its contract of guaranty which a bankruptcy court should recognize as requiring the subordination of the company's interest in the mortgage to the claims of the other mortgage creditors. It is a familiar equity rule applied by the federal courts in liquidation proceedings under federal statutes that a solvent guarantor or surety of an insolvent's obligation will not be permitted, either by taking indemnity from his principal or by virtue of his right of subrogation,

to compete with other creditors payment of whose claims he has undertaken to assure, until they are paid in full. If the surety were allowed to prove his own claim before the creditor is paid, he would to that extent diminish the creditor's dividends upon his claim, and thus defeat the purpose for which he had given the indemnity. *United States* v. *National Surety Co.*, 254 U. S. 73, 76; *Jenkins* v. *National Surety Co.*, 277 U. S. 258; *American Surety Co.* v. *Electric Co.*, 296 U. S. 133; *Peoples* v. *Peoples Bros.*, 254 Fed. 489; *United States Fidelity & Guaranty Co.* v. *Union Bank & Trust Co.*, 228 Fed. 448, 455. For like reasons equity requires the surety who holds security of the insolvent principal to give the benefit of it to the creditor for whom he is surety until the debt is paid. *Keller* v. *Ashford*, 133 U. S. 610; see *Chamberlain* v. *St. Paul, etc. R. R.*, 92 U. S. 299, 306; *Hampton* v. *Phipps*, 108 U. S. 260, 263; 4 Pomeroy, Equity Jurisprudence (5th ed.) § 1419.

But we think the equitable basis for requiring the surety or guarantor to postpone the assertion of rights which he derives from or are incidental to his suretyship, to the rights of creditors whom he has undertaken to secure, is wanting here. The rights asserted by Prudence Company in the mortgage are not those of a subrogee; they were acquired independently of its guaranty. They are not derived from or an incident to it. Their assertion is in no way inconsistent with any duty or obligation it assumed by its contract of guaranty. By that contract the guarantor pledged only its personal obligation for the payment of the certificates. It gave to the certificate holders no lien upon, or other priority right in its interest in the mortgage more than to its other assets.

Postponement of its rights in the mortgage to those of the other certificate holders is not justifiable as operating to avoid circuity of action. The Prudence Company is not solvent. Its property is being liquidated in bankruptcy where all the claimants on its present and other guaranty obligations are entitled to share equally in its unpledged assets. Denial of the right to prove its claim, which is an asset in which all of Prudence's creditors are otherwise entitled to share, will serve only to divert this asset from all creditors to one class of creditors, the Zo-Gale certificate holders, and thus give to them the exclusive benefit of a security for which they have not bargained. Allowance of the Prudence Company's claim does not involve any breach of its duty as guarantor.

Nor does it deprive certificate holders of their right to share in this asset *pari passu* with the other creditors, or of any right, legal or equitable, to which they are entitled by virtue of their position as guaranteed creditors. See *Hampton* v. *Phipps*, *supra*; *Prairie State Bank* v. *United States*, 164 U. S. 227; *Henningsen* v. *United States Fidelity & Guaranty Co.*, 208 U. S. 404.

Since the New York rule, in the absence of an actual agreement to subordinate the guarantor, is merely a general rule of law governing insolvency proceedings, it is not controlling in bankruptcy. And since in the circumstances of the present case we find no agreement and no equitable basis for depriving the Prudence Company and its creditors of the benefits of the usual bankruptcy rule of equality, the judgment below must be

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.